# 2022 AICPA Released Questions

INCLUDING

SURGENT ANSWER EXPLANATIONS

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## 2022 AICPA Released Questions

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# Surgent Question: #202556

**AUD CPA Blueprint:** 1A1 - Nature and Scope: Audit Engagements

**Question Statement:**

Which of the following terms used in the Statements on Auditing Standards indicates a presumptively mandatory requirement?

A. Must
>>B. Should
C. Could
D. Consider

**Surgent Question Explanation:**

This is a definitional question. The Statements on Auditing Standards (SAS) presumptively mandatory requirements are indicated by the word "should." Unconditional requirements are indicated by the word "must."

# Surgent Question: #202557

**AUD CPA Blueprint:** 1B1 - AICPA Code of Professional Conduct

**Question Statement:**

Under the AICPA Code of Professional Conduct, which of the following tax compliance services performed for an attest client relating to the preparation of a tax return would impair a CPA's independence?

A. Signing and filing a client's tax return after receiving written authorization from a client employee who reviewed the return and is qualified to sign the return
>>B. Making tax payments from a client's restricted account over which the CPA has signing authority and control
C. Filing a client-approved tax return electronically
D. Remitting a check payable to a tax authority signed by the client

**Surgent Question Explanation:**

Making payments on an account for which the CPA has signing authority and control is a situation in which the CPA is acting in the capacity of management. Acting in a management capacity would impair the CPA's independence.

Filing a return for the client electronically is permissible and does not violate independence rules. Remitting a check payable to the tax authority that the client (but not the CPA) signed is allowable, as is signing a client's return *after* the client reviewed and authorized the return.

# Surgent Question: #202558

**AUD CPA Blueprint:** 1B2 - Requirements of the Securities and Exchange Commission and the Public Company Accounting Oversight Board

**Question Statement:**

A registered public accounting firm is conducting an audit of an issuer. Which of the following services may the auditor provide to the client while maintaining independence?

A. Drafting documents that form the basis of financial statements filed with the SEC
B. Originating source data underlying the balance sheet
C. Maintaining accounting records
>>D. Preparing an organizational chart of the accounting department

**Surgent Question Explanation:**

The auditor is disallowed from providing any services that would be associated with preparation of financial statements, including any underlying data supporting the financial statements. Drafting documents that form the basis of the statements, originating data that goes into the financial statements (e.g., balance sheet), or maintaining the records that flow into the statements all would violate independence. The auditor would be preparing data that they would then audit.

The only acceptable action in this question is preparing an organizational chart of the client's accounting department. The organizational chart does not appear in or flow through to the financial statements.

# Surgent Question: #202559

**AUD CPA Blueprint:** 1B2 - Requirements of the Securities and Exchange Commission and the Public Company Accounting Oversight Board

**Question Statement:**

In which of the following circumstances is a registered public accounting firm's independence impaired with respect to an issuer?

A. The firm is a member of a trade association that is an audit client.
B. The firm's affiliate provides tax advisory services to a member of the board of directors of the issuer.
>>C. The firm recommends a human resources software system to the issuer and receives a commission from the software vendor.
D. The firm advises the issuer on the tax consequences of alternative ways of structuring a transaction after receiving approval of the audit committee.

**Surgent Question Explanation:**

Receiving a commission for recommendations or referrals of products or services is a direct independence violation.

The firm and client are permitted to be in a similar trade or social association. Tax advisory services from an affiliate to a board member are permissible, as is providing clear guidance on tax consequences of an action after approval from the audit committee. Note that tax services for a potential outcome are not permissible if not approved by the audit committee.

# Surgent Question: #202560

**AUD CPA Blueprint:** 1C2 - Terms of Engagement and Engagement Letter

**Question Statement:**

Which of the following items most likely would be included in the engagement letter prepared by an auditor?

A. Drafts of account confirmations sent to financial institutions
B. Meeting dates, attendance, and topics at board of directors' meetings
C. Lists of current and previous lawyers retained by the entity
>>D. Services to be provided in addition to the audit

**Surgent Question Explanation:**

An audit engagement letter should include the engagement's objective and scope (i.e., services provided), the auditor's responsibilities, management's responsibilities, the applicable reporting framework, references to the form and content of reports to be delivered, and a statement qualifying any limitations.

Drafts of confirmations would be included in the audit workpapers, not the engagement letter. Meeting dates, attendance, and topics of board meetings would be documents prepared by the client and provided to the auditor, not engagement letter components. Lists of lawyers would be collected as part of the sending of legal letters and included in the audit workpapers, not the engagement letter.

# Surgent Question: #202561

**AUD CPA Blueprint:** 1C2 - Terms of Engagement and Engagement Letter

**Question Statement:**

For an engagement to prepare financial statements, which of the following items should be identified in the engagement letter as management's responsibility?

A. The preparation of financial statement disclosures
B. The determination of the level of assurance over the financial statements
>>C. The accuracy of significant judgments to be used in the preparation of the financial statements
D. The inclusion of the financial reporting framework description on the face of the financial statements

**Surgent Question Explanation:**

An engagement letter to prepare financial statements on behalf of management should state that management is responsible for the accuracy of significant judgments to be used, among other items such as management's responsibility for the detection of fraud.

Financial statement disclosures are the responsibility of the accountant, not management. Neither party discloses the framework on the face of the financial statements. No assurance is provided over financial statement preparation engagements.

**Helpful Hint:** When you see "level of assurance," you should always think accountant or auditor, not management.

 

# Surgent Question: #202562

**AUD CPA Blueprint:** 1D - Requirements for Engagement Documentation

**Question Statement:**

Which of the following is a primary purpose of audit documentation?

>>A. To support that the audit was performed in accordance with GAAS
B. To prevent legal liability related to the audit performed
C. To assure that fraudulent financial reporting did **not** occur
D. To maintain professional judgment

**Surgent Question Explanation:**

Audit documentation is prepared and maintained to support the basis for opinion reached by the auditor and support that the audit was performed in accordance in GAAS.

Audit documentation, if properly supported, may reduce legal liability, but it does not prevent it nor is it the primary reason documentation is retained. Audits are performed with reasonable, not absolute, assurance; the statements are free of material fraud or error. Judgment is potentially used in audit documentation, but it is not the primary reason audit documentation is prepared.

**Helpful Hint:** This is one of those problems where you are asked to choose the *best* answer from multiple possible *correct* answers.

# Surgent Question: #202563

**AUD CPA Blueprint:** 1F - A Firm's System of Quality Control, Including Quality Control at the Engagement Level

**Question Statement:**

If an audit firm determines that a quality control review is required, but it has not yet been performed, what should an audit engagement partner do?

A. Issue an unqualified audit report with an explanatory paragraph.
>>B. Refrain from issuing the audit report until after the quality control review has been completed.
C. Issue a qualified audit report with an explanatory paragraph.
D. Request that the audit engagement team members perform the quality control review in a timely manner.

**Surgent Question Explanation:**

The engagement partner on an engagement undergoing a quality control review should not release an attest report until the quality control review is completed.

Issuing an unqualified or qualified report would be inappropriate until the review is completed. The engagement should not discuss the issues, findings, or process of a quality control review until the review is completed.

# Surgent Question: #202564

**AUD CPA Blueprint:** 2A1 - Developing an Overall Engagement Strategy

**Question Statement:**

Which of the following statements is correct regarding the auditor's responsibility to detect errors and fraud?

A. The auditor should design and execute an audit that will provide complete assurance that the financial statements are free of material errors or fraud.
B. The auditor's opinion provides absolute assurance that the financial statements are free of material errors or fraud.
C. The auditor is **not** responsible for detecting material misstatements resulting from management fraud.
>>D. The auditor should design the audit to provide reasonable assurance of detecting errors and fraud that are material to the financial statements.

**Surgent Question Explanation:**

Auditors perform an audit to provide reasonable (not absolute or complete) assurance that the financial statements are free from material error or fraud. The auditor is responsible for detecting material frauds or errors, even if the assurance provided around this responsibility is not absolute.

# Surgent Question: #202565

**AUD CPA Blueprint:** 2A2 - Developing a Detailed Engagement Plan

**Question Statement:**

Which of the following accounts would an auditor most likely test prior to the balance sheet date?

A. Interest receivable
B. Accrued liabilities
C. Short-term debt
>>D. Maintenance and repairs expense

**Surgent Question Explanation:**

The only choice here that is not a balance sheet account is maintenance and repairs expense, and therefore would be the most likely to be tested prior to the balance sheet date since the income statement is "for the period ended" and not as of a given date.

Interest receivable, accrued liabilities, and short-term debt are all balance sheet accounts that need to be tested as of the balance sheet date.

# Surgent Question: #202566

**AUD CPA Blueprint:** 2C2 - Business Processes and the Design of Internal Controls, Including IT Systems

**Question Statement:**

A treasury department overstated its company's cash position by neglecting to account for a $200,000 wire transfer. Which of the following internal controls could have detected the error?

>>A. Performing monthly reconciliations of all bank accounts
B. Requiring that all outgoing wire transfers be approved by management
C. Requiring internal auditors to perform analytical procedures on cash balances
D. Including the daily bank activity statements as backup to the monthly entries in the cash receipts journal

**Surgent Question Explanation:**

A monthly reconciliation of all bank accounts would have detected that $200,000 was transferred out of the account but not recorded in the company's general ledger. There would have been no corresponding journal entry supporting the transfer.

Requiring approval, while a good control, would not have caught the missed record. Analytical procedures would not have caught the omission if the omission amount fell within the tolerable threshold of the internal audit team. Including backups to monthly entries would not catch individual omissions.

# Surgent Question: #202567

**AUD CPA Blueprint:** 2C2 - Business Processes and the Design of Internal Controls, Including IT Systems

**Question Statement:**

An auditor was testing whether shipments were made only to creditworthy customers. The client informed the auditor that the information technology system would not print bills of lading for customers that were on credit hold. The auditor would most likely next perform which of the following?

A. Select a sample of customers on credit hold, attempt to print bills of lading for these customers, and verify with the information technology department that only a few customers are on credit hold.
>>B. Attempt to print a bill of lading for one customer on credit hold and verify with the information technology department that this control **cannot** be overridden without approval.
C. Review recent shipments for a sample of customers on credit hold and verify with the accounting manager that all shipments were shipped by the due date.
D. Review the customer files for the names of all customers on credit hold and verify with the accounting manager that **no** shipments were made to these customers after they were listed on credit hold.

**Surgent Question Explanation:**

This appears to be an automated control since the problem states the "system would not print bills of lading" if credit holds existed. The next step would then be to verify this automatic control operates as designed by attempting to print a bill of lading for a customer with a hold and confirm that this control cannot be overwritten without prior approval.

The next best answer, "select a sample of customers on credit hold," is not correct because automated controls do not need large samples. In theory, if they work once, they will work every time. Secondly, the number of customers on hold is irrelevant to the control.

Reviewing shipments for customers on hold would not provide evidence about the shipment while the customer was on hold. Shipments could have occurred prior to the customer being placed on hold. Also, verifying no shipments have occurred is insufficient because that could indicate that no orders were placed. It does not necessarily provide evidence that the control was working if a customer on hold attempted to order goods.

# Surgent Question: #202568

**AUD CPA Blueprint:** 2E3 - Further Procedures Responsive to Identified Risks

**Question Statement:**

In the integrated audit of a nonissuer, in order to obtain evidence to form an opinion on the effectiveness of internal control over financial reporting, an auditor will perform each of the following procedures, **except:**

A. reviewing misstatements detected during the financial statement audit.
B. reviewing tests of controls performed during the financial statements audit.
>>C. reviewing matters related to the entity's capital structure.
D. reviewing reports issued during the year by the internal audit department.

**Surgent Question Explanation:**

An entity's capital structure is the mix of stock and debt funding the entity uses to finance its operations. That is *unrelated* to internal controls.

Reviewing reports by the internal audit department will help identify control failures or design deficiencies. Reviewing misstatements would be undertaken, as a misstatement likely indicates the control environment failed to prevent a material misstatement. Reviewing tests of controls is one way to review evidence that operational effectiveness is explicitly operating or not.

# Surgent Question: #202569

**AUD CPA Blueprint:** 2E3 - Further Procedures Responsive to Identified Risks

**Question Statement:**

Which of the following statements is correct with respect to the testing of controls in an audit of an issuer's financial statements?

A. An auditor should assess control risk at **less** than the maximum for all relevant assertions.
>>B. An auditor must obtain evidence that controls are operating effectively during the entire period of reliance if the auditor plans to assess control risk at **less** than the maximum.
C. The evidence necessary to support an auditor's control risk assessment usually does **not** depend on the degree of reliance the auditor plans to place on the effectiveness of a control.
D. Tests of controls are **not** required to be performed on assertions for which substantive procedures alone provide insufficient audit evidence.

**Surgent Question Explanation:**

For an auditor to assess control risk below the maximum level, the auditor must obtain evidence that controls are operating effectively during the period of reliance—otherwise, if controls were not effective, lowering control risk below the maximum level would not be appropriate as there would not be evidence to support any reliance strategy.

Tests of controls *are* required when substantive testing fails to produce sufficient audit evidence.

 

# Surgent Question: #202570

**AUD CPA Blueprint:** 2F1 - For the Financial Statements as a Whole

**Question Statement:**

An auditor determined materiality for planning purposes before year-end based on a nonissuer entity's prior-year financial statements. During the audit, the auditor learns that the actual financial results are significantly different from those of the prior year because of a merger. The auditor's most appropriate response would be to:

A. reassess the risk of material misstatement to determine whether detection risk remains appropriate.
>>B. revise materiality for the financial statements as a whole.
C. reperform audit procedures completed before year-end.
D. reevaluate the sufficiency of audit procedures performed in the prior-year audit.

**Surgent Question Explanation:**

If new information is identified that would change the auditor's level of materiality, the auditor should reassess the initial materiality calculation and revise materiality for the financial statements taken as a whole, if necessary. Failure to do so will lead to an inefficient audit (if materiality is set too low) or a potentially ineffective audit (if materiality is set too high).

Reperforming procedures, assessing detection risk, or assessing prior-year evidence would not be relevant to potential changes in materiality.

# Surgent Question: #202571

**AUD CPA Blueprint:** 2F2 - Tolerable Misstatement and Performance Materiality

**Question Statement:**

Which of the following statements is correct with regard to the consideration of materiality when an auditor is planning and performing a financial statement audit of an issuer?

>>A. When determining a tolerable misstatement threshold, an auditor should take into account the amount of misstatements that were accumulated in prior periods.

B. An auditor should determine a tolerable misstatement threshold at the overall financial statement level, but **not** at the account or disclosure level.

C. An auditor does **not** need to express materiality as a specified, quantitative amount.

D. When the reevaluation of materiality results in a significantly lower amount than initially established, an auditor would generally **not** modify audit procedures.

**Surgent Question Explanation:**

Materiality is the level at which an amount, transaction, or disclosure could influence the decisions of financial statements users. It includes current misstatements and those accumulated in prior periods. Materiality is expressed in quantitative terms—risks can be assessed quantitatively or qualitatively.

Tolerable misstatement is the application of performance materiality (PM). PM refers to the materiality level set for specific account balances, disclosures, and transactions.

If new information is identified that would change the auditor's level of materiality, the auditor should reassess the initial materiality calculation and revise materiality for the financial statements taken as a whole, if necessary. Failure to do so will lead to an inefficient audit (if materiality is set too low) or a potentially ineffective audit (if materiality is set too high).

# Surgent Question: #202572

**AUD CPA Blueprint:** 2G - Planning for and Using the Work of Others

**Question Statement:**

In which of the following circumstances can an auditor rely on an internal auditor's work?

A. When there was reliance on the internal audit department in the prior year's audit
B. When the operations are comparable to the prior year's operations
C. When the auditor considers the internal auditors to be objective because they report directly to the corporate controller
>>D. When the auditor can make a positive assessment of the internal audit department's objectivity and competence

**Surgent Question Explanation:**

For an auditor to rely on the client's internal audit (IA) department, the auditor must independently assess the IA department to be competent and objective in their work. IA departments deemed either not objective or not competent should not be relied upon and the auditor must increase the extent of their own testing.

Prior-year reliance does not support current-year audit work. The internal audit department could have changed policies, procedures, personnel, and/or had a reduction in objectivity and competency since the prior-year audit. The comparability of operations between years is unrelated to IA's reliance. IA reporting to the controller would likely lead to less reliance, not more. Ideally, IA reports to the board of directors and the audit committee.

# Surgent Question: #202573

**AUD CPA Blueprint:** 2H1 - An Entity's Compliance with Laws and Regulations, Including Possible Illegal Acts

**Question Statement:**

An auditor's responsibility for a client entity's compliance with laws and regulations impacting the entity is to:

A. prevent noncompliance with applicable laws and regulations.
B. ensure that operations are conducted in accordance with laws and regulations.
C. detect any noncompliance with applicable laws and regulations.
>>D. identify material misstatements in the entity's financial statements due to noncompliance with applicable laws and regulations.

**Surgent Question Explanation:**

An auditor is responsible for identifying material misstatements due to noncompliance with laws and regulations. This is consistent with their general responsibility to provide reasonable assurance that the financial statements are free from material misstatements regardless of origin.

It is management's responsibility, often via internal controls and the control environment, to prevent noncompliance and ensure operations are conducted lawfully. Management's systems of internal controls are designed to detect instances of noncompliance, not the auditor's, as long as they do not lead to material misstatements in the financial statements.

# Surgent Question: #202574

**AUD CPA Blueprint:** 3B - General Procedures to Obtain Sufficient Appropriate Evidence

**Question Statement:**

With regard to the performance of audit sampling during the audit of a nonissuer client, which of the following statements is correct?

A. Professional judgment is **not** a valid justification in deciding whether to use a statistical or nonstatistical sampling approach.
B. Sample size is a valid criterion in deciding between a statistical or nonstatistical sampling approach.
>>C. The level of sampling risk that the auditor is willing to accept affects the sample size.
D. The sampling unit must be stated in monetary terms.

**Surgent Question Explanation:**

The level of sampling risk is inversely correlated with sampling size. As the auditor accepts more risk, the sample size decreases.

Sampling units can be monetary or they can be qualitative (e.g., invoices, inventory quantities). Sample size is not a valid criterion for determining sampling approach—the makeup of the population, coupled with the auditor's professional judgment, determines sampling approach.

# Surgent Question: #202575

**AUD CPA Blueprint:** 3B - General Procedures to Obtain Sufficient Appropriate Evidence

**Question Statement:**

In an audit of a nonissuer's defined benefit pension plan, which of the following procedures most effectively tests that benefit payments to plan participants are paid in accordance with the plan document?

>>A. Recalculating benefits for selected participants based on the plan provisions using relevant service and salary history to support the recorded benefits paid to the participants

B. Inquiring of the plan administrator about the internal control procedures in place to ensure that the benefit payments to plan participants are paid in accordance with the plan provisions

C. Sending confirmations to plan participants to ascertain that the amount paid to them in the fiscal year is the same as recorded in the general ledger account related to benefit payments

D. Testing the accuracy and completeness of benefit payments made to plan participants and comparing the benefit payments recorded in the general ledger to the benefit payment records in participant records

**Surgent Question Explanation:**

Defined benefit plans are commonly referred to as pension plans. They afford the beneficiary a fixed benefit in retirement based upon the plan agreement. Such payments typically are based on the beneficiary's age, salary, length of service, and a set rate per these factors. Given the payments are set contractually, the auditor should recalculate the expected payment amount and compare it to the actual payment amount.

Inquiry of the plan administrator is an important internal control evidence-gathering activity, but it is not sufficient to test the actual payments. Sending confirmations confirms receipt of the payment, but it does not confirm whether the payment was made in the accurate amount per the plan documents. Comparing the benefits recorded in the general ledger (GL) to the payments does not test the accuracy of such payments. The client could have calculated and paid the wrong amount, but they would still agree in the GL.

# Surgent Question: #202576

**AUD CPA Blueprint:** 3C2 - External Confirmations

**Question Statement:**

Which of the following auditing procedures would provide the best audit evidence in testing the existence of the accounts receivable balance?

>>A. Obtaining confirmation of receivables directly from customers
B. Tracing sales register selections into the accounts receivable listing
C. Obtaining a management representation letter regarding accounts receivable
D. Testing shipping cutoff procedures

**Surgent Question Explanation:**

The best evidence for testing an accounts receivable (AR) balance is the customer with the outstanding balance confirming the existence and amount of the balance. It confirms the existence and dollar value associated with an individual balance.

The next best option would be to obtain support for the cash payment of the balance when paid by the customer.

None of the other options would be sufficient. Tracing sales to the AR listing only supports that the entries were entered in a matched manner; it does not support that the AR balance actually exists. Testing shipping cutoff procedures is a control procedure that does not support the balance in AR. A management representation letter regarding AR would provide review evidence, not audit evidence.

# Surgent Question: #202577

**AUD CPA Blueprint:** 3C2 - External Confirmations

**Question Statement:**

From which of the following populations most likely would a sample be drawn by an auditor who is confirming accounts receivable as of June 30?

A. Bills of lading for goods shipping prior to June 30
B. Customer payments received subsequent to June 30
>>C. The accounts receivable detail listing as of June 30
D. Customer sales agreements signed subsequent to June 30

**Surgent Question Explanation:**

An auditor wishing to obtain evidence confirming accounts receivable (AR) balances/amounts as of June 30 would start with the makeup of the accounts receivable balance via the accounts receivable detail listing. From there, the auditor would select accounts that are in the reported balance sheet balance and confirm their existence with the customer responsible for the balance.

Customer payments received after June 30 would support the existence of a balance at June 30 but would not be useful in selecting a sample of the population of AR balances as the payments may or may not be related to AR balances.

Sales agreements do not indicate a receivable balance is associated as the balance would not be created until the service/product was provided by the client, which may or may not be the sales agreement date. Bills of lading would confirm goods are shipped but not that a balance was related to them—goods shipped could be for cash sales, prepaid sales, or consignment transactions.

 

# Surgent Question: #202578

**AUD CPA Blueprint:** 3D4 - Litigation, Claims, and Assessments

**Question Statement:**

For which of the following responses in a legal letter would an auditor most likely qualify the audit opinion for a scope limitation?

A. The response is limited to only those items that the attorney has devoted substantial attention.
B. The attorney is unable to respond as to the outcome of the matter because of inherent uncertainty.
>>C. The response specifically excludes information on a pending legal matter because of publicity concerns.
D. The attorney is unable to provide a reasonable estimate of a probable loss arising from a legal matter.

**Surgent Question Explanation:**

An auditor should qualify the audit opinion for a material scope limitation when the auditor is unable to obtain sufficient appropriate audit evidence to support the opinion and that evidence is limited to amounts that are not pervasive. Publicity concerns indicate the information is known but the client has failed to authorize the auditor to access it and would be a client-imposed scope limitation.

The other three answer choices—attorney-only items, estimation difficulties, and uncertainty—are standard issues that do not limit the scope. For example, the auditor cannot make a lawyer estimate a liability if the estimate is unknown.

# Surgent Question: #202579

**AUD CPA Blueprint:** 3D4 - Litigation, Claims, and Assessments

**Question Statement:**

An auditor is in the process of identifying any pending litigation claims against the client that might require disclosure in the audited financial statements. Which of the following steps should the auditor take first to acquire information regarding litigation?

A. Request that management mail a letter of inquiry to the client's legal counsel.
>>B. Inquire about and discuss any potential litigation with management.
C. Send a letter of inquiry to the client's legal counsel.
D. Examine contracts for potential violations.

**Surgent Question Explanation:**

The auditor should perform the following steps when seeking to identify pending litigation, in order:

1. *Inquire about and discuss any potential litigation with management.*
2. Request that management prepare, on their letterhead, a letter of inquiry to their counsel.
3. The auditor obtains and mails the letter.
4. Counsel returns the letter directly to the auditor.

Contract examination should be performed as part of the general audit process, but it is not directly tied to pending litigation. Legal counsel of the client is the best source of such audit evidence.

 

# Surgent Question: #202580

**AUD CPA Blueprint:** 3D5 - An Entity's Ability to Continue as a Going Concern

**Question Statement:**

In an audit of a nonissuer, each of the following factors may raise substantial doubt about the nonissuer's ability to continue as a going concern for a reasonable period of time, **except:**

A. internal work stoppages.
B. negative financial trends.
C. underinsured catastrophe coverage.
>>D. plans to dispose of fully depreciated assets.

**Surgent Question Explanation:**

Fully depreciated assets imply that the assets have met or exceeded their useful life and therefore are likely to be of minimal continuing benefit to the nonissuer. If the nonissuer was selling off productive and still useful assets, that could raise doubt about the nonissuer's ability to continue as a going concern.

Work stoppages (e.g., canceling shifts, shutting down plants), negative financial trends (e.g., operating losses and negative cash flows), and underinsured catastrophe coverage are all indicators that doubt exists about the entity's ability to continue as a going concern.

# Surgent Question: #202581

**AUD CPA Blueprint:** 3D5 - An Entity's Ability to Continue as a Going Concern

**Question Statement:**

Which of the following factors would most likely raise substantial doubt about a nonissuer's ability to continue as a going concern?

>>A. The bankruptcy of the nonissuer's primary supplier as a result of declining margins and performance in the industry

B. A loss of key management personnel in accordance with the succession plan instituted by those charged with governance

C. A substantial decline in net income as a result of one-time charges for obsolete inventory in an otherwise profitable reporting unit

D. The modification of an outstanding bank note that results in an impending balloon payment being refinanced and paid over a period of 10 years

**Surgent Question Explanation:**

The nonissuer's primary supplier undergoing bankruptcy due to declining margins and industry performance would suggest that the nonissuer will also experience declining margins and declining performance as the supplier is supplying the same industry as the nonissuer.

Loss of management following a new succession plan would be considered standard. For example, if a member not in the management team was named as the CEO in waiting and the current COO or CFO stepped down, that would be a negative indicator. One-time charges are not typically related to broad financial troubles, particularly when they occur in a profitable segment. Refinancing debt to achieve more favorable terms is also good business practice and not indicative of financial distress.

# Surgent Question: #202582

**AUD CPA Blueprint:** 3E - Misstatements and Internal Control Deficiencies

**Question Statement:**

An auditor's evaluation of uncorrected misstatements for an audit of an issuer should include evaluation of the effects of uncorrected misstatements detected in:

>>A. the prior years and misstatements detected in the current year that relate to prior years.
B. the current year that relates to prior years, but **not** misstatements detected in prior years.
C. the prior years, but **not** misstatements detected in the current year, that relate to prior years.
D. the prior years or misstatements detected in the current year that relate to prior years, but **not** both.

**Surgent Question Explanation:**

Documentation surrounding uncorrected misstatements should include the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods and those identified in the current period under audit.

# Surgent Question: #202583

**AUD CPA Blueprint:** 3F - Written Representations

**Question Statement:**

Which of the following is the principal reason for the requirement to obtain a management representation letter from client management?

A. To reduce reliance on employee-completed internal control questionnaires
B. To reduce reliance on analytical procedures that have been performed
C. To replace assertions in the legal representation letter
>>D. To complement other auditing procedures that have been performed

**Surgent Question Explanation:**

Obtaining a management representation letter is a required audit procedure and its intended purpose is to complement and support other auditing procedures that have been performed.

It is not designed to replace, reduce, or alter reliance on procedures performed elsewhere in the audit. It does not replace assertions in the legal representation letter but could be used to complement such assertions.

# Surgent Question: #202584

**AUD CPA Blueprint:** 3G - Subsequent Events and Subsequently Discovered Facts

**Question Statement:**

Which of the following procedures would **least** likely help the auditor discover a subsequent event at the conclusion of the audit?

A. Reviewing and analyzing the latest available interim financial statements
B. Reviewing the minutes of meetings with the board of directors
>>C. Reviewing the audit working papers
D. Obtaining a legal letter from the client's attorney

**Surgent Question Explanation:**

Audit evidence obtained and the associated workpapers support the financial statements as of the balance sheet and/or period-end dates. For example, sales are tested in the year under audit and balances are tested as of the balance sheet date. Collected evidence, except in limited circumstances (e.g., search for unrecorded liabilities, cutoff testing), does not support subsequent event discovery.

Reviewing interim financial information for material changes, reviewing board minutes, and obtaining legal letters that could detail potential legal liabilities that existed as of the balance sheet date would all be beneficial in discovering subsequent events.

# Surgent Question: #202585

**AUD CPA Blueprint**: 3G - Subsequent Events and Subsequently Discovered Facts

**Question Statement:**

Which of the following procedures would most likely help an auditor identify events after the date of the financial statements that should be disclosed?

A. Review changes in the interest rate for cash accounts.
B. Follow up on accounts receivable confirmations that were **not** returned for additional loss accruals.
>>C. Inquire about changes in capital stock that was issued or repurchased.
D. Evaluate depreciation schedules for additional depreciation expense.

**Surgent Question Explanation:**

The purpose of subsequent procedures is to mainly identify events that occurred after the balance sheet date but have a material impact on the financial statements presented as of the balance sheet date. Changes in capital stock could indicate issuance or repurchase of stocks that were planned as of the balance sheet date.

Changes in interest rates for cash accounts occur daily and would not indicate subsequent event-related evidence. If AR confirmations are not returned, the auditor is required to obtain sufficient appropriate audit evidence in other ways (e.g., tracing cash receipts) during fieldwork. Depreciation changes are standard and do not indicate subsequent event transactions.

# Surgent Question: #202586

**AUD CPA Blueprint:** 4A2 - Form and Content of an Audit Report, Including the Use of Emphasis-of-Matter and Other-Matter (Explanatory) Paragraphs

**Question Statement:**

In an audit of an issuer's financial statements, the auditor determined that there was substantial doubt about the issuer's ability to continue as a going concern for a reasonable period of time. If there were no other significant audit findings, which of the following indicates the proper form of the audit report that should be issued?

A. A disclaimer of opinion
B. An adverse opinion with an other-matter paragraph
>>C. An unqualified opinion with an explanatory paragraph
D. A qualified opinion with an emphasis-of-matter paragraph

**Surgent Question Explanation:**

An issuer who has substantial doubt about their ability to continue as a going concern, but no material misstatements or GAAS departures, will still receive an unqualified audit opinion with an explanatory paragraph. Material GAAP or GAAS departures would require a qualified, adverse, or disclaimed opinion. As none of these situations are present, an unqualified opinion is the most appropriate.

# Student Question: #202587

**AUD CPA Blueprint:** 4C1 - Preparation Engagements

**Question Statement:**

During an engagement to prepare financial statements, an accountant was precluded by management from including a statement on each page of the financial statements indicating that **no** assurance is provided. Which of the following actions would be appropriate?

Issue an adverse opinion on the financial statements.

>> Issue a disclaimer making clear that **no** assurance is provided.

Limit the distribution of the financial statements to specific users.

Perform sufficient procedures to allow the accountant to provide limited assurance on the financial statements.

**Surgent Question Explanation:**

When preparing financial statements for management, accountants should obtain an agreement with management for the financial statements to include a statement on each page of the financial statements that no assurance is provided. If management refuses, the accountant is required to issue a disclaimer.

# Surgent Question: #202588

**AUD CPA Blueprint:** 4C2 - Compilation Reports

**Question Statement:**

If an accountant compiles financial statements for an entity and a member of the engagement team has a direct financial interest in the entity, then the accountant should:

A. issue a report for the preparation of client financial statements.
>>B. indicate the accountant's lack of independence in a final paragraph of the compilation report.
C. include a statement on each page of the financial statements that the accountant is **not** independent.
D. disclose in the notes to the financial statements a description of the reason the accountant's independence is impaired.

**Surgent Question Explanation:**

An accountant is not required to be independent for compilation engagements. However, if the accountant is not independent, the accounting must disclose the lack of independence in the final paragraph of the compilation report prepared by the accountant.

Note disclosures and page disclosures are not appropriate. A single reference in the report is sufficient. The report must include reference to the lack of independence. Issuing a standalone report without reference to the lack of independence would be an independence violation.

# Surgent Question: #202589

**AUD CPA Blueprint**: 4E1 - Comparative Statements and Consistency Between Periods

**Question Statement:**

A nonissuer changes from an accounting principle not in accordance with the applicable reporting framework to an accounting principle in accordance with the applicable reporting framework. How should the auditor characterize such a change?

A. As a change in reporting entity
B. As a change in accounting principle
>>C. As a correction of a misstatement
D. As a change in classification

**Surgent Question Explanation:**

A change in principle from one not in accordance with applicable reporting frameworks (e.g., U.S. GAAP) to a principle consistent with such frameworks represents a correction of error and previously misstated financials to corrected financials. This would be a correction of a misstatement.

The change is not a change in reporting entity as no consolidation or groups are discussed. Principle changes are not classification changes. A change in accounting principle is only appropriate if the change is from one accepted principle to another accepted principle (e.g., LIFO inventory to FIFO inventory). It is not the correct classification when one of the principles is not supported by the appropriate reporting framework.

# Surgent Question: #202590

**AUD CPA Blueprint**: 4E6 - Special-Purpose and Other Country Frameworks

**Question Statement:**

If an auditor is reporting on financial statements of a nonissuer prepared in accordance with a financial reporting framework generally accepted in a country other than the United States and the auditor uses the other country's report form and content for use only outside the United States, then the auditor should:

A. issue a similar U.S. form of the report to only those parties specified by the audit client.
B. include an other-matter paragraph in the audit report identifying the significant differences between the reporting framework of the other country and the reporting framework of the United States.
C. obtain approval of the comparable U.S. regulatory authority prior to issuing the report in the form and content of the other country.
>>D. comply with the reporting standards of the other country and identify the other country in the report.

**Surgent Question Explanation:**

If an auditor is reporting on financial statements prepared under a financial reporting framework of another country and those financial statements are only for use outside of the United States, the auditor should comply with the reporting standards of the other country only and identify the other country in the report.

The auditor could use a U.S. form report, but it would not be limited to only those parties specified by the client. They need not indicate reference to the differences between the United States and the other country or obtain regulatory approval. The auditor is permitted to issue an audit report for financial statements prepared under another reporting framework.

# Surgent Question: #202591

**AUD CPA Blueprint**: 4E6 - Special-Purpose and Other Country Frameworks

**Question Statement:**

If a U.S. auditor is reporting on financial statements of a nonissuer prepared in accordance with a financial reporting framework generally accepted in another country and intended for use only outside the United States, then the auditor:

A. is required to use the report form and content of the other country provided that, in similar circumstances, such a report would be issued by auditors in that country.
>>B. should report using either a U.S. form of report or the report form and content of the other country as long as the requirements for that report have been met.
C. must issue both a report in the form and content of the other country and a modified U.S. form of report stating that the financial statements are **not** prepared in accordance with U.S. GAAS.
D. is required to use a U.S. form of report stating that the financial statements being reported on have been prepared in accordance with the financial reporting framework accepted in another country.

**Surgent Question Explanation:**

If an auditor is reporting on financial statements prepared under a financial reporting framework of another country and those financial statements are only for use outside of the United States, the auditor should comply with the reporting standards of the other country only and identify the other country in the report ***or*** issue a U.S. form of the report that reflects the statements were prepared using another country's reporting framework.

The auditor is not required to use only a U.S. form, only a form of the other country, or both. The auditor could report under any report form based on their judgment.

# Surgent Question: #402632

**BEC CPA Blueprint:** 1A2 - Enterprise Risk Management Components and Principles

**Question Statement:**

Company management completes event identification and analyzes the associated risks. The company wishes to assess its risk in the absence of any actions management might take to alter either the risk's likelihood or impact. According to COSO, which of the following types of risk does this situation represent?

>>A. Inherent risk
B. Residual risk
C. Event risk
D. Economic risk

**Surgent Question Explanation:**

This is a definitional-type question. Inherent risk is risk that exists before management takes any steps to control the likelihood or impact of such risk.

Residual risk is the risk that remains after management responds to inherent risk. Event risk relates to individual events regardless of management, likelihood, or impact. Economic risk is related to the overall health of the economy and is unrelated to management actions.

# Surgent Question: #402633

**BEC CPA Blueprint**: 1A2 - Enterprise Risk Management Components and Principles

**Question Statement:**

A company's performance guidelines set a lower limit of 3% unfavorable material usage variance for its production facility. In applying the COSO enterprise risk management (ERM) framework, which of the following principles most closely aligns with the establishment of this performance guideline?

A. Identifying risk
B. Assessing substantial change
>>C. Formulating business objectives
D. Demonstrating commitment to core values

**Surgent Question Explanation:**

Under the 2017 COSO ERM framework, formulating business objectives assesses objectives at various levels of business and strategy that align to the organization's strategy and goals. Setting guidelines (e.g., 3% variance) is a direct business objective that can be implemented.

It is not an identification of risk as the company is setting a standard, not identifying what risks could cause a change in guidelines or standards. It is not assessing substantial change as it is establishing the threshold, nor is it demonstrating commitment to core values. Core values are not strategic financial thresholds. They more represent the high-level goals, beliefs, and values of the company (e.g., creating an inclusive environment).

 

# Surgent Question: #402634

**BEC CPA Blueprint:** 1B1 - Internal Controls Purpose and Objectives

**Question Statement:**

According to COSO, management should be concerned with the effectiveness of the monitoring processes of an entity regarding internal controls over financial statement preparation for each of the following reasons, **except:**

A. effective monitoring provides incentive for employees to perform their duties properly over time.

B. effective monitoring enables those charged with governance to determine whether the internal control processes continue to operate effectively over time.

C. effective monitoring allows those charged with governance to identify and correct deficiencies before they materially affect financial statements.

>>D. effective monitoring assists those charged with governance to ensure that the entity meets its operating and financial expectations.

**Surgent Question Explanation:**

Controls over financial statement preparation relate to the effective operation and design of controls to reduce the risk that material errors, frauds, or omissions appear in the financial statements. They must be able to correct deficiencies that could materially impact the financial statements taken as a whole, be effective over time, and incentivize employees to perform their duties related to such controls.

The entity meeting its operating or financial expectations, while an important goal of an organization, is *not* within the scope of COSO internal controls.

# Surgent Question: #402635

**BEC CPA Blueprint:** 1B2 - Internal Controls Components and Principles

**Question Statement:**

According to COSO, which of the following organizational structures best promotes internal control?

Divisional internal audit staff with indirect reporting to the corporate director of internal audit, who in turn reports to the audit committee

Divisional internal audit staff with indirect reporting to the corporate director of internal audit, who in turn reports to the CFO

Corporate internal audit staff with direct reporting to the corporate director of internal audit, who in turn reports to the CFO

>> Corporate internal audit staff with direct reporting to the corporate director of internal audit, who in turn reports to the audit committee

**Surgent Question Explanation:**

The most objective line of reporting is the director of corporate (not divisional) internal audit (IA) reports directly to the audit committee, not management (e.g., the CEO or CFO). Divisional IA staff can still report to corporate IA staff and directors.

It is less appropriate for the director of IA to report directly to the CFO because if IA finds fraud or an error related to the CFO, they would be reporting to the potential perpetrator.

# Surgent Question: #402636

**BEC CPA Blueprint:** 1B2 - Internal Controls Components and Principles

**Question Statement:**

An entity’s recording and reporting processes are highly automated, and the information system produces much of the information used for monitoring controls. Which of the following statements is correct regarding the entity’s monitoring of controls?

A. Because the processes are automated, management can be sure that controls are processed in a correct manner.
>>B. Any errors in the information provided by the system could lead management to incorrect conclusions regarding controls.
C. Management will likely be unable to monitor system controls effectively in such a highly automated environment.
D. Effective monitoring of application controls over specific applications of the information system can overcome deficiencies in the design of general controls.

**Surgent Question Explanation:**

Errors in automated systems and processes could lead management to incorrect conclusions regarding the controls if management perceives the information to be accurate.

Automated processes are still subject to inaccuracies. That is why automated controls are tested. Management can monitor controls regardless of their process, manual and automated. Monitoring cannot overcome deficiencies, but it can help identify and correct deficiencies.

# Surgent Question: #402637

**BEC CPA Blueprint:** 1C - Business Processes

**Question Statement:**

Lightning E-Retailing maintains a virtual inventory. When a customer orders an item, the system contacts the firm's suppliers, who then deliver the goods required to Lightning the next day. This practice is facilitated most by which of the following technologies?

A. Electronic funds transfer
>>B. Electronic data interchange
C. Client-server
D. Wide area network

**Surgent Question Explanation:**

Electronic data interchange (EDI) shares and transmits business information between partners in a standardized format. Partners can be customers, suppliers, resellers, and delivery firms, among others. Virtual inventory monitoring between partners matches this definition.

Electronic funds transfer refers to transferring cash between accounts, not inventory. Client-server refers to the server where a client stores information and does not relate to coordination. Wide area networks are networks that cover a wide area and relate to internal connections and communications.

# Surgent Question: #402638

**BEC CPA Blueprint:** 1C - Business Processes

**Question Statement:**

A transaction processing system would appropriately include each of the following activities for an online bookseller, **except:**

A. shipping.
B. processing payroll.
C. receiving internet orders.
>>D. monitoring competitor price changes.

**Surgent Question Explanation:**

A transaction processing system is an internal system that manages transactions, often between various users or departments, within an organization. For an online bookseller it would include the full sales transaction: receiving of the order, confirming the order, preparing the order for shipping, and billing. It would also include paying personnel for their work, recording hours worked (for hourly employees), and processing their payroll.

It would *not* include external monitoring such as reviewing competitor price changes, as that is not an internal transaction or event.

# Surgent Question: #402639

**BEC CPA Blueprint:** 1C - Business Processes

**Question Statement:**

In the processing of sales orders, which of the following documents authorizes the warehouse to send goods to the shipping department?

A. Packing slip
B. Customer purchase order
>>C. Picking ticket
D. Sales order

**Surgent Question Explanation:**

The picket ticket instructs the warehouse operators to pull the ordered goods from their storage location at the warehouse and deliver them to the shipping department (but not yet ship them).

A packing slip is included along with the final goods ordered and informs the consumer what goods are in the shipping container/box and what quantity. A customer purchase order is a request to purchase goods—it shows intent to buy, not final purchase approval. The sales order confirms the purchase order contents and is provided by the seller to the buyer. None of the options other than the picket ticket authorizes warehouse personnel to send goods to the shipping department.

# Surgent Question: #402640

**BEC CPA Blueprint:** 2A - Economic and Business Cycles - Measures and Indicators

**Question Statement:**

A decrease in which economic indicator would most appropriately encourage a business owner to move forward on a planned expansion?

A. Stock prices
B. Building permits
C. Commercial loans
>>D. Initial claims for unemployment

**Surgent Question Explanation:**

A decrease in people filing for unemployment would indicate economic conditions are heading in a bullish or positive direction as more people working (less people unemployed) leads to more people earning wages and having spending power.

A fall in stock prices would be a negative indicator of where the economy was heading. A decrease in building permits would indicate people are dialing back expansion plans and bracing for an economic decline, while a decline in commercial loans would indicate banks tightening lending requirements in preparation for an economic downturn.

# Surgent Question: #402641

**BEC CPA Blueprint:** 2A - Economic and Business Cycles - Measures and Indicators

**Question Statement:**

Projections indicate that the economy is entering a slowdown. What is the expected outcome in the near future?

A. Inflationary pressures
B. Increasing demand for credit
C. Wage hikes
>>D. A drop in interest rates

**Surgent Question Explanation:**

In times of economic slowdown, *interest rates are lowered* by central banks to encourage spending, demand for credit declines as spending declines, and unemployment increases while wages decrease or remain flat.

Inflationary pressures can exist in boom cycles and bust cycles. In fact, some central banks may respond to inflationary pressures by taking actions that could lead to a recession. However, inflationary pressures on their own do *not* indicate a slowdown.

# Surgent Question: #402642

**BEC CPA Blueprint:** 2B - Market Influences on Business

**Question Statement:**

If a company's output is increasing at 100% while its input is increasing at 80%, the cause is most likely the company's:

A. diminishing returns.
>>B. economies of scale.
C. diseconomies of scale.
D. comparative advantage.

**Surgent Question Explanation:**

In this scenario, the company is increasing outputs at a rate that exceeds input, meaning the company is being more efficient in its production. This is likely due to economies of scale, where the company is producing closer to the optimal amount of goods to take full advantage of production capacity, labor, and materials.

Diseconomies of scale and diminishing returns would be reflected in inefficient production, not efficient production. Comparative advantage is not relevant here as that is a product or brand indicator relative to other brands, not internal metrics.

# Surgent Question: #402643

**BEC CPA Blueprint:** 2B - Market Influences on Business

**Question Statement:**

A firm has a perfectly inelastic supply curve, and it faces a downward-sloping demand curve. Which of the following results best describes an increase in demand when the supply curve is constant?

A. Price will rise, and quantity will increase.
>>B. Price will rise, and quantity will be constant.
C. Price will fall, and quantity will increase.
D. Price will fall, and quantity will be constant.

**Surgent Question Explanation:**

A perfectly inelastic supply curve is a vertical supply curve. Supply is then fixed at all price levels. Therefore, an increase in demand via a shift in the demand curve would lead to the same level of production at a higher price.

**Study Hint:** Remember, an increase in *quantity* demanded moves us along the demand curve, while an increase in demand shifts the curve.

# Surgent Question: #402644

**BEC CPA Blueprint:** 2C1 - Market, Interest Rate, Currency, Liquidity, Credit, Price, and Other Risks

**Question Statement:**

Each of the following statements is correct regarding the impact of exchange rates on operations, **except:**

A. a real depreciation of the domestic currency results in higher prices for imported goods.
B. a real depreciation of the domestic currency lowers the price for domestic goods relative to foreign goods.
C. a real appreciation of domestic currency raises the price of domestic goods relative to foreign goods.
>>D. a real appreciation of domestic currency hurts domestic importers and consumers because imported goods cost more.

**Surgent Question Explanation:**

A currency that appreciates rises in value relative to the comparison currency. For example, if you are currently based in Japan and need 100 yen to buy $1 but a week later need only 95 yen to buy $1, the yen has appreciated against the dollar. This would make imports cheaper as now less yen buys the same amount of imported goods, helping, not hurting, domestic importers. However, it makes domestic (Japanese) goods more expensive to foreign buyers as they have to offer more dollars to get the same amount of goods in yen. The inverse is true for a depreciating currency.

# Surgent Question: #402645

**BEC CPA Blueprint:** 2C1 - Market, Interest Rate, Currency, Liquidity, Credit, Price, and Other Risks

**Question Statement:**

Which of the following external factors would increase the inherent risk of a highly leveraged audit client that has closely monitored profit expectations and imports most of its resale inventory from Europe?

>>A. An increase in the prime interest rate
B. A change in the management of the marketing department
C. A low rate of inflation
D. A stronger dollar relative to the euro

**Surgent Question Explanation:**

A change in the prime rate would increase borrowing costs for a company with high debt (i.e., highly leveraged), reducing the risk they could borrow further, and potentially reduce the likelihood European sellers would contract with them.

A stronger dollar relative to the euro would make it cheaper to buy goods, reducing risk. A low rate of inflation would imply more consistent interest rates and prices, reducing risk through less variability. A change in marketing management would be unrelated from an audit standpoint. However, a change in CEO, CFO, or head of the finance department would all potentially impact the preparation and presentation of the financial statements and increase risk.

# Surgent Question: #402646

**BEC CPA Blueprint:** 3A - Capital Structure

**Question Statement:**

Freemont, Inc. plans to offer a bond issue but first wants to estimate the cost of debt capital. The corporation plans to issue 2,000 bonds at 7% with $1,000 face value. Freemont's investment bankers estimate the market rate to be 7% when the corporation issues its bonds. Freemont's effective tax rate is 37%. What percentage is the estimated cost of debt capital of Freemont's planned issuance?

A. 2.59%
>>B. 4.41%
C. 7.00%
D. 8.82%

**Question Explanation:**

The cost of debt can be found by applying the cost of debt, operationalized by the interest rate associated with the debt, by (1 – Tax rate) since interest on debt is tax deductible. That leads to a cost of debt of 4.41% (7% × (1 – 37%)).

**Study Hint:** If you answered 2.59%, you likely forgot to deduct the tax rate from 1 before applying it to the cost of debt.

# Surgent Question: #402647

**BEC CPA Blueprint:** 3A - Capital Structure

**Question Statement:**

Macro Corp. issues $3 million of $10,000 face amount debenture bonds with a coupon rate of 9% and an effective interest rate of 8%. With interest payable semiannually, what total amount will be disbursed on each interest payment date?

$120,000
>> $135,000
$240,000
$270,000

**Surgent Question Explanation:**

Interest payments are based on the coupon, or stated, rates. In this instance, the face value of the bonds is $10,000 and the stated rate is 9% (4.5% semiannually), making the interest payment $135,000 ($3 million × 9% × 6/12).

Note that interest expense would be based on the effective interest and carrying amount of the bonds.

# Surgent Question: #402648

**BEC CPA Blueprint:** 3B1 - Fundamentals and Key Metrics of Working Capital Management

**Question Statement:**

A company is considering two possible $100,000 loans at 5%. Loan X requires four equal payments over four years, whereas Loan Y requires one lump-sum payment at the end of the fourth year, with annual payments of interest expense. Which of the following statements is correct regarding the effect of the two loans on the company's working capital?

>>A. At the end of year 1, Loan X would result in a lower ending working capital.
B. At the end of year 2, Loan X would result in a higher ending working capital.
C. At the end of year 3, both loans would have the same effect on working capital.
D. At the end of year 4, both loans would have used the same amount of working capital.

**Surgent Question Explanation:**

Working capital is current assets less current liabilities. Loan X would reduce working capital in year 1 as current assets (cash) would decrease and current liabilities would remain unchanged. Loan Y would lead to a decrease in working capital when it recognized interest expense and the associated payable, but the interest ***and*** principal payment on Loan X would be larger in absolute size.

Similar to the explanation above, in year 2 and year 3 Loan X would lead to the lowest working capital as it paid down the loan, with interest, each year.

At the end of year 4, Loan Y would have a lower reduction in working capital because the company will have to pay interest on the full $100,000 balance each year while the balance in Loan X has been declining annually, resulting in a net lower amount of cash paid.

**Study Hint:** The best way to address questions like this on the exam is to take them out of the conceptual and use real numbers.

# Surgent Question: #402649

**BEC CPA Blueprint:** 3B1 - Fundamentals and Key Metrics of Working Capital Management

**Question Statement:**

The current ratio of a company is 1.5. Which of the following transactions will cause the current ratio to increase?

>>A. Payment on accounts payable
B. Cash received from an account receivable
C. Purchase of inventory on account
D. Purchase of equipment for cash

**Surgent Question Explanation:**

The current ratio is current assets over current liabilities. To increase the ratio, a company must either increase current assets (numerator) or decrease current liabilities (denominator). The only answer that matches that is payment on accounts payable, a transaction that decreases liabilities.

Cash received for receivables has no impact on the current ratio as it is a swap of current assets. Purchase of equipment for cash reduces, not increases, current assets. Purchasing inventory (current asset) with accounts payable (current liability) will cause the overall ratio to decrease (see below).

**Study Hint:** The best way to address questions like this is to take them out of the conceptual and use real numbers. Assume current assets (CA) are 12 and current liabilities (CL) are 4 for a current ratio of 3 (12/4). If we buy inventory of 2 on account CA is now 14 and CL is now 6, for a current ratio of 2.33, a reduction from the previous 3.

# Surgent Question: #402650

**BEC CPA Blueprint:** 3C - Financial Valuation Methods and Decision Models

**Question Statement:**

Which of the following assumptions applies to the basic theory underlying the capital asset pricing model?

>>A. A single risk-free rate exists.
B. The variability of returns is unrelated to stock prices.
C. The required return for a particular stock **cannot** be measured.
D. The total variability can be divided into three separate components.

**Surgent Question Explanation:**

A capital asset pricing model (CAPM) assumes the risk-free rate of return is known and fixed, implying a single rate.

The variability of returns via stock prices is reflected in the beta coefficient embedded in CAPM. The required return is reflected in the expected market premium. Variability, also called risk, is broken into two, not three, components. Those components are systematic risk and unsystematic risk.

# Surgent Question: #402651

**BEC CPA Blueprint:** 3C - Financial Valuation Methods and Decision Models

**Question Statement:**

Which of the following assumptions applies to the basic theory underlying the Black-Scholes option-pricing model?

A. The call option can be exercised at any time before its expiration date.
>>B. There are **no** transaction costs for buying or selling the stock or option.
C. The stock underlying the call option pays dividends during the life of the option.
D. Purchasers of the underlying securities **cannot** borrow any of the proceeds used to buy the securities.

**Surgent Question Explanation:**

The Black-Scholes-Merton option-pricing model, commonly referred to as Black-Scholes, is used to estimate the fair value of options. Its major assumptions are as follows:

1. The options are European.
2. The risk-free rate is fixed.
3. Volatility is fixed.
4. No dividends are paid.
5. Markets follow a random walk.
6. Option exercise occurs at expiration regardless of the exercise period.

There is also the assumption that buying and selling the securities or options is *costless.* There is no assumption that the purchasers cannot borrow to buy the securities.

# Surgent Question: #402652

**BEC CPA Blueprint:** 4A - Understanding of Information Technology (IT)

**Question Statement:**

What is the most effective way that the information technology people, processes, and systems can facilitate an organization's overall strategic decision-making process?

A. By providing improved security of critical information assets
B. By providing online real-time processing for all transactions
>>C. By providing relevant and reliable data that reduce uncertainty
D. By providing large amounts of unfiltered data to decision makers

**Surgent Question Explanation:**

The only answer that improves and facilitates strategic decision making is reliable data that reduces uncertainty. This allows decision makers to make decisions with accurate (i.e., reliable) data.

Decision makers need organized and filtered data, not unprocessed/unfiltered data. Overall strategic decision making does not need real-time data. Strategic decision making is long-term in nature. While improved security of information assets is a noteworthy objective, it does not facilitate the strategic decision-making process.

# Surgent Question: #402653

**BEC CPA Blueprint:** 4A - Understanding of Information Technology (IT)

**Question Statement:**

A distributed data processing (DDP) model involves reorganizing the IT function into small units that are distributed to end users and placed under their control. Which of the following is **not** an advantage of such a model?

A. It reduces costs by allowing data to be entered and edited locally.
>>B. It enables an organization to exert greater control over its IT environment.
C. It enhances user satisfaction by allowing users to control the resources that influence their profitability.
D. It provides the ability to back up computing facilities to protect against potential hazards such as fires and flood.

**Surgent Question Explanation:**

Distributing the IT function into small units under control of the end user allows local computer control and backup. Because control is at the local level, it is more difficult for the organization to exert control from the top, *not* easier.

All of the other answer choices are *advantages* of DDP: It reduces costs by allowing data to be entered and edited locally; it enhances user satisfaction by allowing users to control the resources that influence their profitability; and it provides the ability to back up computing facilities to protect against potential hazards such as fires and flood.

# Surgent Question: #402654

**BEC CPA Blueprint:** 4C1 - General IT Controls

**Question Statement:**

Which of the following strategies involving systems design is most likely to provide the best result from the standpoint of ensuring effective control procedures?

>>A. Integrating general and application control procedures into the components as part of the basic design
B. Adding general and application control procedures to the design after the basic development has been completed
C. Adding general and application control procedures during system conversion
D. Integrating general and application control procedures after implementing the system

**Surgent Question Explanation:**

All of the answer choices include integrating general and application controls at the same time. The question is then asking you at what stage they should be integrated/added.

The best answer choice is the earliest possible stage provided so that they are considered as part of the comprehensive systems design strategy and do not become an afterthought. The earliest possible stage is into the components as part of the basic design.

Integration after the basic design, during conversion, or after system implementation is too late in the cycle and may require amendments to previous strategies to fully integrate control procedures after the fact.

# Surgent Question: #402655

**BEC CPA Blueprint:** 4C2 - Logical and Physical Controls

**Question Statement:**

A company's financial reporting system has a process management feature to provide workflow control. This feature allows the division accounting staff to input and review data and send the data to the company's corporate office for final review and approval. What security access, if any, should be granted to the division accounting staff once the data has been sent to the corporate office for approval?

>>A. Read but **not** write
B. Write but **not** read
C. Both read and write
D. No access

**Surgent Question Explanation:**

Once the data has been processed by the staff and carried through to the corporate office, the data should not be able to be edited or written over without being reassigned to the staff and resubmitted to the corporate office. Since the staff prepared the data, the ability to read the data at the stage is still appropriate as they may need it for operations.

# Surgent Question: #402656

**BEC CPA Blueprint:** 4C2 - Logical and Physical Controls

**Question Statement:**

Which of the following pairs of techniques best provides for roughly the same level of assurance about the enforceability of a digitally signed transaction as an inked signature provides for a paper-based transaction?

A. Hashing and symmetric encryption
>>B. Hashing and asymmetric encryption
C. Data masking and symmetric encryption
D. Data masking and asymmetric encryption

**Surgent Question Explanation:**

Hashing involves the conversion of plaintext into a short code called a hash. Like an inked signature, hashing is not reversible. An asymmetric key involves only one party having access to the private key while a symmetric encryption involves both parties having access to the key. As in an inked signature with only one signer, the asymmetric encryption is the closest match.

# Surgent Question: #402657

**BEC CPA Blueprint:** 4D2 - Extract, Transform, and Load Data

**Question Statement:**

During the process of transforming raw data into information that can be used in a relational database, which of the following must be used to create a relationship between two tables?

>>A. A foreign key
B. The primary key
C. A data dictionary
D. A conceptual-level schema

**Surgent Question Explanation:**

A foreign key is an attribute in one table that is a primary key in another table. It is used to link tables.

The primary key is a necessary but not sufficient component to link tables. A data dictionary merely describes the data; it does not aid in linking tables. A conceptual-level scheme is unrelated to relationship creation between two tables; it instead focuses on the design of the overall database storing data.

 

# Surgent Question: #402658

**BEC CPA Blueprint:** 5A - Financial and Nonfinancial Measures of Performance Management

**Question Statement:**

A company uses the gross profit method to determine cost of goods sold and inventory levels on an interim basis. The company miscalculated its costs in one of its product lines and is using an overstated gross profit rate for the year. What impact could this have on the company's operation?

A. The company could believe that it has **less** inventory than it actually has and thus purchase more than it needs.
B. The company could erroneously believe that it has to raise its selling price to make its profit margin goal.
>>C. The company could mislead its bank, making it believe that the company has more collateral for its loan than it actually has.
D. The company's CFO could erroneously believe that it was time to withdraw the product line.

**Surgent Question Explanation:**

Overstatement of gross profit (Sales – COGS (cost of goods sold)) results from sales being too high or COGS being too low. The only answer consistent with that is the company making it appear as if they have more collateral than they do. This is because COGS being too low means not enough goods were taken out of inventory and transferred into COGS, leading to COGS being understated and inventory being *overstated.* This overstatement would lead a bank to think the company had more assets to pledge as collateral than they actually held.

As noted above, for gross profit to be overstated, inventory must be too high, not too low. An overstated profit margin would lead the company to believe it could lower, not raise, its selling price and still hit its goals. An improving gross profit would suggest a continuance of the product line, not a reduction.

# Surgent Question: #402659

**BEC CPA Blueprint:** 5B1 - Cost Measurement Concepts, Methods, and Techniques

**Question Statement:**

Citrus Corp. produces three products in its plant: Juice, Pulp, and Zest. Zest has the following per-unit revenue and cost characteristics:

| | |
|---|---|
| Price | $20 |
| Variable manufacturing cost | 8 |
| Fixed manufacturing cost | 5 |
| Variable selling cost | 4 |
| Fixed selling cost | 3 |
| Variable administrative cost | 2 |
| Fixed administrative cost | 1 |

Which of the following decisions is best for Citrus?

>>A. Continue to produce Zest because it makes a $6 per-unit contribution to the overall operation.
B. Continue to produce Zest because it makes an $11 per-unit contribution to the overall operation.
C. Discontinue production of Zest because it incurs a loss of $3 per unit.
D. Discontinue production of Zest because it makes a contribution of $11 but does not cover the remaining $14 of variable cost.

**Surgent Question Explanation:**

Zest's per-unit contribution margin (selling price less variable costs) is $6 ($20 − $8 Variable manufacturing cost (VMC) − $4 Variable selling cost (VSC) − $2 Variable administrative cost (VAC)). Fixed costs cannot be avoided in the short term and therefore are not relevant to the decision-making process.

The only answer choice with the correct contribution is the answer that states Zest should continue to be produced at the $6 contribution margin rate.

 

# Surgent Question: #402660

**BEC CPA Blueprint:** 5B1 - Cost Measurement Concepts, Methods, and Techniques

**Question Statement:**

Total costs for the production of 10,000 units were $100,000. Variable costs were $60,000. If 15,000 units were produced, what would be the total costs?

>>A. $130,000
B. $150,000
C. $160,000
D. $180,000

**Surgent Question Explanation:**

Total costs are fixed costs plus variable costs. Variable costs are $6/unit ($60,000 ÷ 10,000 units) and fixed costs are $40,000 ($100,000 total − $60,000 variable).

For a production of 15,000 units, total costs would be $130,000 ($40,000 fixed + ($6 × 15,000 units)).

# Surgent Question: #402661

**BEC CPA Blueprint:** 5C1 - Approaches, Techniques, Measures, and Benefits to Process-Management Driven Businesses

**Question Statement:**

Which of the following statements about an organization's value chain is correct?

A. The value chain considers only the internal processes of a company.
>>B. The value chain consists of the major value-added functions for an organization.
C. The value chain is **not** concerned with post-production functions.
D. The value chain is **not** concerned with pre-production functions.

**Surgent Question Explanation:**

Value chain analysis concerns viewing business processes, both internal and external, as a sequence of events and activities that add value to the business. It includes pre-production (inbound logistics), operations, post-production (outbound logistics), and support activities.

# Surgent Question: #402662

**BEC CPA Blueprint:** 5C2 - Management Philosophies and Techniques for Performance Improvement

**Question Statement:**

Which of the following terms represents a valid in-process control measure that would normally assess product quality before production is completed?

>>A. Random inspection
B. Variance analysis
C. Machinery bottleneck identification
D. Scrap cost yield analysis

**Surgent Question Explanation:**

The only answer choice that occurs during production/before production is completed is random inspection. This allows management to review products at various stages as they are being produced.

Variance analysis—the analysis that compares budget to actual—is only possible post-production. Scrap cost yield analysis is only available post-production where scraps created during production are set aside and later sold. Bottleneck identification is also only usually available post-production where processing times are compared across segments of production.

# Surgent Question: #402663

**BEC CPA Blueprint:** 5D1 - Budgeting and Analysis

**Question Statement:**

A company is planning to market a new product. The original cost and profit calculations are as follows:

| | |
|---|---|
| Factory overhead (based on 40% direct labor) | $120 |
| Gross profit (25% of sales) | 220 |
| Direct materials | 240 |
| Direct labor | 300 |
| Total cost | 660 |
| Selling price | 880 |

When reviewing the final calculations, the controller found that direct labor should be 10% higher. Which of the following correctly calculates the selling price for the product?

1.25 × (($420 × 1.1) + $240)
1.25 × (($300 × 1.1) + $240 + $120)
>> 1.33 × (($420 × 1.1) + $240)
1.33 × (($300 × 1.1) + $240 + $120)

**Surgent Question Explanation:**

Currently, the sales price of the new product is 1.33 ($880 ÷ $660) times the total costs of $660. Therefore, we know that needs to remain constant.

Next, we need to determine what to apply the 10% labor increase to. We know that direct labor ($300) is up 10% and that factory overhead ($120) is a direct function of direct labor. Therefore, we need to increase direct labor (DL) and factory overhead (FOH) by 10% (1.1 × $420).

Lastly, to verify that we recoup our costs, we need to account for direct materials of $240. If we include the $120, we will be double-counting it as we already accounted for FOH when applying the 10% increase.

**Study Hint:** Try and narrow this to two answer choices right off the bat and then work through the remaining two choices. Looking at the information given, we can see that the current sales price is 1.33 ($880 ÷ $660) of total cost. Therefore, we can eliminate the 1.25 choices immediately.

 

# Surgent Question: #302710

**FAR CPA Blueprint:** 1A1 - Conceptual Framework

**Question Statement:**

Which of the following is a qualitative characteristic that enhances the usefulness of financial information?

A. Neutrality
B. Materiality
>>C. Verifiability
D. Confirmatory value

**Surgent Question Explanation:**

Comparability, *verifiabilit*y, timeliness, and understandability are considered the four main factors that enhance the usefulness of financial information.

Materiality is the level at which a piece of information becomes potentially important to users of the statements. Information presented in the financial statements is assumed material.

Neutrality and confirmatory value, while sometimes valuable in different information contexts, do not enhance the usefulness of financial information.

# Surgent Question: #302711

**FAR CPA Blueprint:** 1A2 - Standard-Setting Process

**Question Statement:**

It can be reasonably assumed that the FASB has made an amendment to generally accepted accounting principles when the FASB issues:

A. an exposure draft.
B. a staff accounting bulletin.
>>C. an accounting standards update.
D. a statement on standards for attestation engagements.

**Surgent Question Explanation:**

Amendments to the *Accounting Standards Codification* (ASC) that contain U.S. GAAP are updated through Accounting Standards Updates (ASUs) issued by the FASB.

Exposure drafts occur before the ASU is issued and do not represent a final amendment. The FASB does not have authority to issued standards for attestation engagements as that relates to auditing and assurance services. Staff accounting bulletins are issued by the Securities and Exchange Commission (SEC) and not the FASB.

# Surgent Question: #302712

**FAR CPA Blueprint:** 1B3 - Statement of Comprehensive Income

**Question Statement:**

A company reported the following for the current year:

| | |
|---|---|
| Retained earnings appropriated for plant expansion | $32,500 |
| Correction of understated depreciation expense from prior periods | 9,300 |
| Unrealized loss on available-for-sale debt securities | 8,100 |
| Unrealized gain on foreign currency translation | 3,400 |

The company's current-year net income was $86,500, and the company has a 30% effective income tax rate. What amount of comprehensive income should be reported for the current year?

A. $40,000
B. $76,700
C. $81,800
>>D. $83,210

**Surgent Question Explanation:**

Comprehensive income is net income +/− other comprehensive income (OCI) earned during the period. Items in other comprehensive income are reported net of tax. Comprehensive income is:

- Net income − Unrealized loss (1 – Tax rate) + Unrealized gain (1 – Tax rate) = Comprehensive income
- $86,500 − $8,100 (1 − 0.30) + $3,400 (1 − 0.30) = $83,210

**Note:** Retained earnings does not impact comprehensive income. Net income is closed to retain earnings at year-end. The correction of depreciation from prior periods would impact prior-period income and beginning retained earnings but would have no impact on *current-year* net income or OCI.

# Surgent Question: #302713

**FAR CPA Blueprint:** 1B6 - Notes to Financial Statements

**Question Statement:**

In a company's notes to its financial statements, the first note described significant changes in accounting policies related to valuations of inventory and plant assets. Subsequent notes included a separate note detailing inventories and a separate note detailing plant assets. For which of these subsequent notes, if any, should the company duplicate a description of its changes to significant accounting policies?

A. The plant assets note, but **not** the inventory note
B. The inventory note, but **not** the plant assets note
C. Both the plant assets note and the inventory note
>>D. Neither the inventory note nor the plant assets note

**Surgent Question Explanation:**

The summary of significant accounting policies receives its own note at the beginning of the financial statements. It is admissible to cross-reference the significant accounting policy notes in other sections. However, the description itself should not be duplicated across notes to avoid redundancy.

**Study Hint:** You are told both the inventory and plant assets experienced a policy change. Therefore, you can immediately eliminate the options that only one of the two listed notes would experience a change. That leaves you with the choice of "both" or "neither."

# Surgent Question: #302714

**FAR CPA Blueprint:** 1B7 - Consolidated Financial Statements (Including Wholly Owned Subsidiaries and Noncontrolling Interests)

**Question Statement:**

Pardelle, Inc. acquired 80% of Soran Co.'s outstanding common stock on December 31, year 1. Pardelle's retained earnings total $600,000 and Soran's retained earnings total $400,000 on the acquisition date. What amount should be reported for consolidated retained earnings in the consolidated statement of financial position on the acquisition date?

>>A. $600,000
B. $680,000
C. $920,000
D. $1,000,000

**Surgent Question Explanation:**

When a company obtains control of a subsidiary, typically evidenced by greater than 50% ownership, only the parent (Pardelle) company's retained earnings are carried through in consolidation. The subsidiary's (Soran) retained earnings are eliminated in consolidation and the 20% Pardelle does not own would be eliminated and reallocated to the noncontrolling interest. Pardelle has retained earnings of $600,000, which equals consolidated retained earnings at year-end after Soran's retained earnings are eliminated.

# Surgent Question: #302715

**FAR CPA Blueprint:** 1B7 - Consolidated Financial Statements (Including Wholly Owned Subsidiaries and Noncontrolling Interests)

**Question Statement:**

A U.S. company owns 80% of a non-U.S. company located in a foreign country with a very unstable political and economic climate. In which of the following situations should the U.S. company **not** consolidate its financial statements with the non-U.S. company?

A. The foreign country has currency exchange rate fluctuations on a daily basis.
B. The government of the foreign country has increased the tax rate for all companies that are majority-owned by U.S. companies.
C. The government of the foreign country has required all companies operating within its borders to implement International Financial Reporting Standards.
>>D. The government of the foreign country has recently imposed a number of severe sanctions and controls on all companies that are majority-owned by U.S. companies.

**Surgent Question Explanation:**

This problem is testing the exception to the general rule that all subsidiaries controlled by a U.S. company are consolidated into the parent company's books. In the rare instance when a foreign country has imposed severe sanctions and controls on the U.S. company, effectively rendering it no longer in control of the parent despite the parent's controlling ownership, the U.S. parent may indicate that it does not control the subsidiary and therefore should not consolidate.

Exchange rate fluctuations, changes in tax rates, and the implementation of IFRS (International Financial Reporting Standards) within the foreign borders are not reasons to avoid consolidation. A subsidiary may use IFRS for its own purposes as long as it is converted to U.S. GAAP for domestic (U.S.) reporting.

# Surgent Question: #302716

**FAR CPA Blueprint:** 1C1 - Statement of Financial Position

**Question Statement:**

In year 1, a donor promised to give $100,000 to a nongovernmental, not-for-profit kitchen if it provides 20,000 meals by March 31, year 2. At the end of year 1, the kitchen had provided 20,000 meals. In which line item, if any, should the contribution be reported in the kitchen's statement of financial position at the end of year 1?

A. Cash
B. Deferred revenue
>>C. Contributions receivable
D. The contribution should **not** be reported in the statement of financial position.

**Surgent Question Explanation:**

The statement of financial position presents the assets and liabilities of a not-for-profit entity. At year-end this contribution would be earned as the kitchen has completed their performance obligation, removing deferred revenue as an option. The answer choice "cash" is not correct as the kitchen has not received the cash yet.

Because they have earned the revenue and have yet to receive it, the appropriate classification is *contributions receivable* as they have earned the right to receive $100,000 through providing 20,000 meals.

# Surgent Question: #302717

**FAR CPA Blueprint:** 1C2 - Statement of Activities

**Question Statement:**

In the current year, a nongovernmental, not-for-profit entity incurred $630,000 in expenditures during the year. It also received donated legal services, which otherwise would have cost $40,000, and consumed donated supplies with a value of $15,000. What should the entity report as total expenses in its statement of activities for the current year?

A. $630,000
B. $645,000
>>C. $685,000
D. $670,000

**Surgent Question Explanation:**

The answer choice “$685,000” is correct: $630,000 + $40,000 + $15,000 = $685,000. Since the donated supplies of $15,000 represent an asset to the organization, as this asset is consumed, the fair value equivalent of consumption activities would need to be expensed. Meanwhile, legal services of $40,000 meets the three conditions for being recognized as a contributed service since the expense (1) required specialized skills to perform the activity, (2) the attorneys donating the service possess those skills, and (3) the organization would have to buy legal services if they were not donated.

- $630,000 is incorrect. This excludes donations of $15,000 supplies and $40,000 legal services.
- $645,000 is incorrect. This excludes donations of $40,000 legal services.
- $670,000 is incorrect. This excludes donations of $15,000 supplies.

# Surgent Question: #302718

**FAR CPA Blueprint:** 1D - Public Company Reporting Topics (U.S. SEC Reporting Requirements, Earnings per Share, and Segment Reporting)

**Question Statement:**

Bramble, Inc. reported the following at the end of year 1: revenue, $100,000; assets, $300,000; and operating profit, $50,000. One of Bramble's product lines reported the following at the end of year 1: revenue, $10,000; assets, $35,000; and operating profit, $3,000. Which of the following classifications should Bramble use to describe this product line for financial statement presentation purposes?

A. Operating segment
>>B. Reportable segment
C. Subsidiary
D. Asset group

**Surgent Question Explanation:**

A reportable segment is a definitional classification that must be separately reported if an operating segment meets any of the three following tests:

1. Revenue test: ≥ 10% combined revenues of all operating segments
2. Asset test: ≥ 10% combined assets of all operating segments
3. Profitability test: ≥ 10% profits for non-loss segments or ≥ 10% combined losses for loss segments (summarized)

In this example, the product line has 10% of the total revenues ($10,000 ÷ $100,000) and greater than 10% of the total assets ($35,000 ÷ $300,000). It passes two of these tests and would be a reportable segment.

**Note:** Even though the segment made two test thresholds (assets and revenues), it only needed to meet one of the three possible tests.

# Surgent Question: #302719

**FAR CPA Blueprint:** 1E - Financial Statements of Employee Benefit Plans

**Question Statement:**

A company provides a defined contribution pension plan for its employees. For the plan administrator to report contributions from the company, contributions from participants, benefits paid to participants, and changes in fair value of investments, which of the following financial statements is required?

A. Statement of net assets available for benefit
B. Statement of cash flows
>>C. Statement of changes in net assets available for benefits
D. Statement of changes in financial position

**Surgent Question Explanation:**

The statement of changes in net assets includes all the reasons assets would change during the year: contributions, payments, changes in fair value, and any other gains or losses. It includes cash changes (contributions and payments) and noncash amounts (changes in fair value), making "statement of cash flows" a wrong answer as that statement only focuses on cash changes.

The statement of net assets available for benefit is a snapshot for a point in time; it does not show why the net asset values changed. The statement of changes in financial position is not typically associated with company-provided pension plans.

 

# Surgent Question: #302720

**FAR CPA Blueprint:** 2B - Trade Receivables

**Question Statement:**

A company entered into a loan with a lender for $100,000 and pledged $120,000 of the company's accounts receivable as collateral. The lender does **not** have the right to sell or repledge the accounts receivable. When the company receives the cash for the loan proceeds, what entry, if any, should be made to accounts receivable?

A. Credit accounts receivable $20,000
B. Credit accounts receivable $100,000
C. Credit accounts receivable $120,000
>>D. No entry is made to accounts receivable.

**Surgent Question Explanation:**

Even though the company has offered $120,000 in accounts receivable, no entry is made because the lender does not have the rights to the assets. The rights to the assets remain with the company, meaning they control what to do with the accounts receivable.

Note that the company would likely be required to include a note to the financial statements that some accounts receivable balances are pledged as collateral but the company retains their rights. If the lender had rights to the assets immediately or the company transferred receipt of the receivables to the lender, then an adjustment would be necessary.

# Surgent Question: #302721

**FAR CPA Blueprint:** 2C - Inventory

**Question Statement:**

On December 31 of the current year, Letterman Co.'s cost of goods sold amounted to $1,050,000. However, Letterman's auditors determined the beginning merchandise inventory was understated by $20,000 and the ending merchandise inventory was overstated by $12,000. What is the correct cost of goods sold for the current year?

A. $1,018,000
B. $1,042,000
C. $1,058,000
>>D. $1,082,000

**Surgent Question Explanation:**

The correct cost of goods sold for the current year is $1,082,000.

```
COGS = + Beginning          + Purchases   - Ending
       Over (COGS too low)                Under (COGS too low)
```

In simple notation, cost of goods sold (COGS) is found by adding purchases to beginning inventory and subtracting ending inventory. If beginning inventory is understated, that means the company incorrectly would not have captured the sales of those $20,000 worth of goods. If ending inventory was overstated, it would appear the company sold less than it actually did, understating COGS by $12,000.

Since both errors increase COGS, final COGS is $1,050,000 (Stated COGS) + $20,000 + $12,000 = $1,082,000.

 

# Surgent Question: #302722

**FAR CPA Blueprint:** 2E1 - Financial Assets at Fair Value

**Question Statement:**

At the beginning of the current year, a company held trading debt securities with a fair value of \$250,000. During the year, the company received interest income of \$25,000 from the securities and purchased an additional \$50,000 of trading debt securities. At the end of the current year, the company recognized an unrealized loss of \$20,000 on the trading debt securities held as of the end of the year. What amount should the company report for the trading debt securities in its statement of financial position at the end of the current year?

>>A. \$280,000
B. \$300,000
C. \$305,000
D. \$325,000

**Surgent Question Explanation:**

We are told these debt securities are carried as trading securities ("purchased an additional \$50,000 of trading debt securities"). The other option, not used, would be held-to-maturity securities. Trading securities are carried at fair value with interest earned recognized in net income. Because the loss is unrealized, we can deduce that the company did not sell them and only saw a drop in value. The company would report the securities at their fair value as follows:

- \$250,000 (Beginning balance) + \$50,000 (Purchases) − \$20,000 (Unrealized loss) = \$280,000

# Surgent Question: #302723

**FAR CPA Blueprint:** 2E1 - Financial Assets at Fair Value

**Question Statement:**

On the first day of the year, a donor established a $100,000 irrevocable perpetual trust with a third-party trustee naming a not-for-profit entity as the sole income beneficiary in perpetuity. During the year, the trust earned and distributed $4,000 in income to the entity for unrestricted use. On the last day of the year, the fair value of the trust had increased by $5,000. What amount should the entity report in its year-end statement of financial position as beneficial interest in perpetual trust?

A. $96,000
B. $100,000
C. $101,000
>>D. $105,000

**Surgent Question Explanation:**

The answer choice "$105,000" is correct: $100,000 + $5,000 = $105,000.

Trust investments with readily determinable values must be reported at fair value. Therefore, the entity must recognize both the principal (or corpus) of the irrevocable perpetual trust, as well as the resulting gain of $5,000, as an increase in net assets in its year-end statement of financial position. While the principal of the perpetual trust needs to be maintained indefinitely, the interest earnings of $4,000 is unrestricted and would be recognized as interest revenue. All distributions arising from these interest earnings would be treated as an expense.

- $96,000 is incorrect. The perpetual trust needs to be maintained indefinitely; therefore, the principal would not be impacted by the facts presented in this problem.
- $100,000 is incorrect. This answer choice fails to recognize the gain in fair market value of the irrevocable perpetual trust.
- $101,000 is incorrect. The gain in fair market value should not be deducted from interest earnings.

# Surgent Question: #302724

**FAR CPA Blueprint:** 2F - Intangible Assets - Goodwill and Other

**Question Statement:**

A public business entity has a December 31 year-end reporting period and is aware that a goodwill impairment test must be performed at least once during each reporting period. The entity's controller has compiled a list of four potential dates in year 1 and year 2 to test for goodwill impairment. Assuming that there are no events or circumstances requiring impairment testing between the two scheduled dates, which of the following dates in year 1 and year 2, when viewed together, would comply with appropriate guidance?

A. Year 1, June 20; year 2, December 20
B. Year 1, December 31; year 2, June 30
C. Year 1, December 31; year 2, March 31
>>D. Year 1, April 15; year 2, April 15

**Surgent Question Explanation:**

U.S. GAAP requires public entities to assess their goodwill accounts for impairment at least annually. The April 15 testing dates fall within that timeframe.

The June 20 to December 20 period is longer than annually. The other two options are at least annually but would require a third testing date to cover the full-year period and therefore are not the best answers as they are missing a more recent testing date.

# Surgent Question: #302725

**FAR CPA Blueprint:** 2F - Intangible Assets - Goodwill and Other

**Question Statement:**

In which of the following circumstances would trademarks acquired by an entity most likely be deemed to have an indefinite useful life?

A. The entity pays substantial amounts of money to renew the trademarks.
B. The entity operates in an industry with a rapidly changing regulatory environment governing trademarks.
C. The entity plans to use the trademark until the planned phaseout date of the underlying asset.
>>D. The entity's trademark has a remaining legal life of five years but is renewable at very little cost.

**Surgent Question Explanation:**

If an asset's legal life is easily renewable (evidenced by low cost and/or low effort to renew) it is assumed that the company will take the easy steps to renew it, and its life is considered indefinite until the facts and circumstances change materially.

The paying of substantial amounts would support a definite, not indefinite, life. Planning to use the trademark for only a fixed time would support a definite life as the useful life appears fixed. A rapidly changing industry is indicative of forced obsolescence and indicates a fixed, definite life, not indefinite life.

# Surgent Question: #302726

**FAR CPA Blueprint:** 2H1 - Notes and Bonds Payable

**Question Statement:**

A company issued a financial instrument that unconditionally requires the company to settle the obligation by issuing common stock with a value of $500,000 on the settlement date. How should the company report this instrument in its financial statements?

>>A. As a liability in the balance sheet
B. As an equity instrument in the balance sheet
C. By only disclosing a liability in the notes
D. By only disclosing an equity instrument in the notes

**Surgent Question Explanation:**

An unconditional promise to pay a debt at a fixed point in time matches the definition of a liability. The company owes for a benefit and must pay. The method of payment is not relevant to the existence of the liability.

Note disclosure would be insufficient for a liability with a known dollar value ($500,000) but may be necessary in addition to the balance sheet recognition. An equity instrument would be an asset, not a liability.

# Surgent Question: #302727

**FAR CPA Blueprint:** 2I - Equity

**Question Statement:**

A nongovernmental, not-for-profit entity calculated a $4,000 increase in net assets with donor restrictions for the current fiscal year before consideration of the following:

| | |
|---|---|
| A cash donation designated by the donor as an endowment in perpetuity | $28,000 |
| Net assets released from restrictions | 12,000 |
| A donation received that was designated as a quasi-endowment | 21,000 |

Which of the following should be reported as the increase in net assets with donor restrictions in the current-year statement of activities?

A. $16,000
>>B. $20,000
C. $37,000
D. $41,000

**Surgent Question Explanation:**

The answer choice "20,000" is correct: $28,000 − $12,000 + $4,000 = $20,000.

The nongovernmental, not-for-profit entity should take the $4,000 increase in net assets and add the cash donation of $28,000 as this serves as an example of a donor-imposed restriction. Then, the entity should subtract net assets released from restrictions of $12,000 since the money is now unrestricted.

The donation received of $21,000 that was designated as a quasi-endowment is not factored into the analysis. These quasi-endowments are classified among net assets without donor restrictions since future governing boards could undo the designation.

 

# Surgent Question: #302728

**FAR CPA Blueprint:** 2J - Revenue Recognition

**Question Statement:**

A company signed a five-year contract with a customer in year 1 and agreed to modify the contract at the beginning of year 2. Which of the following is a condition that must be present in order for the contract modification to be accounted for as a separate contract?

A. The original contract is terminated.
B. The price of the original contract remains the same.
C. The performance obligations of the original contract are partially satisfied.
>>D. The scope of the original contract increases through the addition of distinct goods or services.

**Surgent Question Explanation:**

For a contract modification to be accounted for as a separate contract, both (1) the scope of the contract increases through the addition of distinct goods or services and (2) the price of the contract increases consistently with the increased goods or services. If both conditions are not met, the modification is either treated as part of the existing contract or treated as the termination of the existing contract and creation of a new contract. The only one of the two required factors present in the answer choices is the scope increase.

# Surgent Question: #302729

**FAR CPA Blueprint:** 2K - Stock Compensation (Share-Based Payments)

**Question Statement:**

Which of the following statements is correct regarding the Black-Scholes-Merton option-pricing model used to estimate the fair value of stock options granted to employees as part of a company's compensatory stock option plan?

A. The model's formula assumes that option exercises occur at the beginning of an option's contractual term.
B. The model's formula assumes that expected dividends vary over the option's term.
>>C. The model's formula assumes that risk-free interest rates are constant over the option's term.
D. The model is referred to as a lattice model.

**Surgent Question Explanation:**

The Black-Scholes-Merton option-pricing model, commonly referred to as Black-Scholes, is used to estimate the fair value of options. Its major assumptions are as follows:

1. The options are European.
2. *The risk-free rate is fixed.*
3. No dividends are paid.
4. Markets follow a random walk.
5. Option exercise occurs at expiration regardless of the exercise period.

Black-Scholes is a closed-form model, *not* a lattice model.

 

# Surgent Question: #302730

**FAR CPA Blueprint**: 2L - Income Taxes

**Question Statement:**

Which of the following items is considered a permanent book-to-tax difference?

A. Warranty payable
B. Prepaid insurance
>>C. Tax penalties paid to tax authorities
D. Accounting for sales of property under the installment method

**Surgent Question Explanation:**

Permanent differences are book-to-tax differences that originate in one period and never reverse.* Tax penalties and fines paid to tax authorities are never deductible for income tax purposes and create a permanent difference as the taxpayer can never deduct them in the future even though they must be added back to income in the year paid.

Warranties, prepaids, and installment sales all reverse after initial recognition.

*** Remember:** Temporary differences originate in one period and reverse in another.

# Surgent Question: #302731

**FAR CPA Blueprint**: 2L - Income Taxes

**Question Statement:**

A company reported $130,000 in income from continuing operations for its first year of operations. The tax-basis depreciation deduction for the year exceeded GAAP depreciation expense by $12,500, and the warranty accrual exceeded the amount spent for warranty repairs by $8,300. The company properly calculated a $840 increase in its deferred tax liability for the year. If the enacted tax rate for the current year is 20%, what amount of income taxes payable should be reported in the year-end balance sheet?

A. $24,340
>>B. $25,160
C. $26,000
D. $26,840

**Surgent Question Explanation:**

Income taxes payable is found by multiplying taxable income by the enacted tax rate. To solve, taxable income must be found first by adjusting GAAP income for temporary and permanent differences:

- Taxable income = GAAP income +/− Differences = $130,000 − $12,500 excess depreciation + $8,300 expense add-back = $125,800
- Income taxes payable = $125,800 × 20% = $25,160

**Note:** You do not need the $840 increase to solve this problem. It is extra information.

# Surgent Question: #302732

**FAR CPA Blueprint:** 3C - Contingencies and Commitments

**Question Statement:**

A defendant has three outstanding lawsuits at the end of year 1. The estimated loss for the first, second, and third cases are $5,000,000, $2,000,000, and $1,000,000, respectively. The likelihood that the plaintiff will lose the first case is highly probable. The chance of losing the second case is reasonably possible, but not probable. The chance of losing the third case is remote. What amount should the defendant accrue as a contingent liability at the end of year 1?

A. $8,000,000
B. $7,000,000
>>C. $5,000,000
D. $2,000,000

**Surgent Question Explanation:**

For a loss contingency, of which outstanding lawsuits are a specific type, a liability and associated expense are recognized when the risk of loss is at least probable and the amount can be reasonably estimated. The only case that meets this criteria is the first case and the amount is $5 million.

The second case would require a footnote disclosure as its loss can be estimated but its risk of loss is only reasonably possible (a lower likelihood than probable).

The third case would require neither a footnote nor recognition as the risk of loss is remote (the lowest likelihood).

# Surgent Question: #302733

**FAR CPA Blueprint:** 3D - Derivatives and Hedge Accounting (e.g., Swaps, Options, Forwards)

**Question Statement:**

With regard to a fair value hedge, hedge effectiveness is a measure of the extent to which the:

A. cash flows from the hedge transaction offset cash flows from the hedged risk.
B. hedge transaction results in eliminating changes in fair value of the hedged item.
>>C. hedge transaction offsets the exposure to changes in the hedged item's fair value.
D. actual change in the hedge's fair value corresponds to the expected change in the hedge's fair value.

**Surgent Question Explanation:**

A fair value hedge is a classification of hedge transaction that hedges against changes in the fair value of assets, liabilities, or firm commitments by offsetting the exposure to those items' fair value changes.

Hedge effectiveness measured through cash flow offsets is the definition of a cash flow hedge. Hedge effectiveness rarely eliminates changes in fair value and the difference between the actual change and expected change need not correspond to be effective. It does not have to be a perfect 1:1 offset.

# Surgent Question: #302734

**FAR CPA Blueprint:** 3E - Foreign Currency Transactions and Translation

**Question Statement:**

A company that is translating account balances from another currency into U.S. dollars for year-end financial statements should use the current exchange rate as of the date of the balance sheet for which of the following accounts?

A. Revenue
>>B. Accounts receivable
C. Capital stock
D. Retained earnings

**Surgent Question Explanation:**

When translating accounts from a foreign currency to the U.S. dollar at the balance sheet date, only accounts receivable is translated at the current rate.

Revenue is translated at the average rate for the period. Capital stock and retained earnings are carried forward at historical rates or amounts.

# Surgent Question: #302735

**FAR CPA Blueprint:** 3F - Leases

**Question Statement:**

The lessee should recognize amounts probable of being owed under a residual value guarantee as a component of lease payments:

A. at the conclusion of the lease.
B. at **no** time during the lease term.
C. on a straight-line basis during the lease.
>>D. on the commencement date of the lease.

**Surgent Question Explanation:**

From the viewpoint of the *lessee* only, the residual value guarantees are treated as an additional "payment" and capitalized with the underlying asset's payments at the commencement of the lease.

They are not recognized at the conclusion of the lease, must be recognized if probable, and are not recognized straight-line as they are included with other payments.

# Surgent Question: #302736

**FAR CPA Blueprint:** 3G - Nonreciprocal Transfers

**Question Statement:**

Which of the following types of agreement represents a split-interest arrangement?

A. A perpetual trust naming ABC as sole beneficiary
>>B. A charitable remainder trust
C. A direct bequest to ABC in the donor's will
D. A direct gift to ABC to be made by the donor next year

**Surgent Question Explanation:**

"A charitable remainder trust" is correct. When trusts provide that the organization must share resources with another beneficiary, this agreement represents a split-interest arrangement. Split-interest agreement are categorized into five types: 1) perpetual trusts held by third parties, 2) charitable gift annuities, 3) charitable lead trusts, 4) pooled income funds, and 5) charitable remainder trusts. A charitable remainder trust represents a split-interest agreement because the donor has designated a specified percentage or dollar amount of the trust's principal and earnings to be paid to a third-party beneficiary, such as a surviving spouse or child (in addition to the money that is being retained by the recipient organization).

The answer choices "a perpetual trust naming ABC as sole beneficiary," "a direct bequest to ABC in the donor's will," and "a direct gift to ABC to be made by the donor next year" are all incorrect. Under all these arrangements, ABC has exclusive rights to the entire portion of the donation. In other words, it is not having to divide (or share) the donation amongst other third parties, such as a surviving spouse or child; therefore, these arrangements do not represent split-interest agreements.

# Surgent Question: #302737

**FAR CPA Blueprint:** 3G - Nonreciprocal Transfers

**Question Statement:**

In year 4, a nongovernmental, not-for-profit school began a campaign to raise funds for a proposed capital addition. The following information is available as of June 30, year 4:

| Information | Amount |
|---|---|
| Received on February 1, year 4: cash contributions from parents and alumni | $450,000 |
| Received on February 1, year 4: unconditional promises to give, of which $300,000 was received as of June 30, year 4 | 600,000 |
| Received on March 1, year 4: a promise from a year 1 alumnus to give $50,000 if other year 1 alumni give a total of $50,000 before September 30, year 5 | 50,000 |
| Received on June 30, year 4: cash contributions from year 1 alumni in response to March 1, year 4, alumni challenge | 20,000 |

What amount of cash contributions for this campaign should the school report in its June 30, year 4, statement of activities?

A. $770,000
B. $1,050,000
>>C. $1,070,000
D. $1,090,000

**Surgent Question Explanation:**

The answer choice "1,070,000" is correct: $450,000 + $600,000 + $20,000 = $1,070,000.

Both the $450,000 in cash contributions from parents and alumni given on February 1 and $20,000 in cash contributions given by alumni on March 1 would be considered unconditional cash donations, therefore recognized in the current period. The $600,000 in unconditional promises is also recognized as a contribution as gifts, grants, bequests, etc. are reported in the period they are unconditionally promised or received, whichever is earlier. The $50,000 intention to give is not recognized because the money is contingent (or conditional) upon another individual matching the donation within the year.

- $1,090,000 is incorrect. The $50,000 March 1 donation is a conditional promise to give and cannot be recognized in the current period.
- $1,050,000 is incorrect. This answer choice excludes $20,000 in cash contributions received on June 30.

- $770,000 is incorrect. While this answer choice correctly incorporates $600,000 in unconditional promises and $20,000 in cash contributions, the $50,000 March 1 donation is a conditional promise to give and cannot be recognized in the current period. Furthermore, the answer appears to inappropriately account for an additional $100,000 in matching contributions that have not yet been realized.

# Surgent Question: #302738

**FAR CPA Blueprint:** 3I - Software Costs

**Question Statement:**

In year 1, a corporation incurred $3,500,000 of costs related to the development of a new software product. Of these costs, $1,000,000 was incurred after technological feasibility was established. The product development was completed and the product was available for sale to customers early in year 2. The corporation estimated that revenues from the sale of the new product would be $1,200,000 over five years. What amount of expense should the company report for year 1?

A. $500,000
B. $700,000
>>C. $2,500,000
D. $3,500,000

**Surgent Question Explanation:**

Once feasibility is established, internally developed software costs can be capitalized. Therefore, of the $3.5 million in costs incurred in year 1, the first $2.5 million ($3.5 million total − $1 million post-feasibility) would be expensed as incurred in year 1 and the remaining $1 million would be capitalized and amortized beginning once the product was ready for sale in year 2.

# Surgent Question: #302739

**FAR CPA Blueprint:** 3K - Fair Value Measurements

**Question Statement:**

When the recoverability of a building's carrying amount is determined to be impaired, the building's fair value is best measured as:

A. the price the building can be sold for in an advantageous market.
B. the selling price **less** transaction costs to complete the sale for this type of building in its principal market.
>>C. the price that would be received for this type of building based on observable inputs in its principal market.
D. the price determined using internal cost estimates to construct a similar building.

**Surgent Question Explanation:**

Fair value for an asset is the price at which the asset could be sold between willing parties in its principal (not best) market. The fair value does not consider transaction costs and does not consider internal cost factors as internal markets are not the principal market. The market is to be priced in its principal, not most advantageous, market.

# Surgent Question: #302740

**FAR CPA Blueprint:** 4A3 - Purpose of Funds

**Question Statement:**

Old Town added a water and sewer department to its municipal services. The department provided the services to the residents of Old Town and issued quarterly billings to customers. In which of the following types of funds would this activity be recorded?

A. Special revenue
B. Capital projects
C. Permanent
>>D. Enterprise

**Surgent Question Explanation:**

The answer choice "enterprise" is correct. Enterprise funds are used when a government offers a service to the public on a user-charge basis. Since Old Town is providing water and sewer services and issuing quarterly billings to customers (citizens), the GASB requires the use of an enterprise fund. In fact, the most common application of government enterprise funds is public utilities, such as water and sewer services.

- "Special revenue" is incorrect. This fund is used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest. Revenues are typically sourced from grants and restricted-use tax sources.
- "Capital projects" is incorrect. This fund is used to account for and report financial resources that are restricted, committed, or assigned for capital outlays like the purchase or construction of major capital improvements, except those purchased or constructed for use by an enterprise or internal service fund. Since Old Town's water and sewer activities are self-sustaining, all construction activities would most likely be accounted for within the enterprise fund.
- "Permanent" is incorrect. This fund is used to account for and report resources that are restricted to the extent of earnings, not principal. Interest earnings must be spent on specific general government programs not supported on a cost-recovery basis.

# Surgent Question: #302741

**FAR CPA Blueprint:** 4B1 - Government-wide Financial Statements

**Question Statement:**

A local government should report expenses, **excluding** special or extraordinary items, by which of the following in its government-wide statement of activities?

>>A. Function
B. Major source
C. Major then minor funds
D. Descending order by amount

**Surgent Question Explanation:**

The answer choice "function" is correct. Direct expenses, including depreciation, are required to be reported by function (e.g., public safety, education, parks and recreation, general government) on the government-wide statement of activities. Indirect expenses, such as interest expense, may be allocated by function or reported as a separate and distinct row.

- "Major source" is incorrect. This refers to program revenues, not expenses. Program revenues are deducted from the expenses incurred for that function to derive the net (expenses) revenues of that function. Program revenues are reported in one of the following three columns: (1) charges for services, (2) operational grants and contributions, or (3) capital grants and contributions. All other revenues are general revenues and reported by major source in the lower section of the government-wide statement of activities.
- "Major then minor funds" is incorrect. Fund reporting occurs when performing modified accrual accounting, not full accrual basis reporting as used when preparing the government-wide statement of activities.
- "Descending order by amount" is incorrect. Expenses may be presented in any order (regardless of amount) on the government-wide statement of activities; however, it is most common to list general government expenses first.

# Surgent Question: #302742

**FAR CPA Blueprint:** 4D6 - Nonexchange Revenue Transactions

**Question Statement:**

A local government recorded revenues as follows: personal income tax, $200,000; sales taxes, $100,000; and property taxes, $150,000. What should the local government report as total derived tax revenue?

A. $100,000
B. $150,000
>>C. $300,000
D. $450,000

**Surgent Question Explanation:**

Derived tax revenues are those revenues that result from *assessments on* exchange transactions. Those transactions are commonly taxes on income or sales taxes. In this case, that is the $200,000 personal income tax and the $100,000 of sales taxes for a total derived tax revenue of $300,000.

Property taxes are classified as imposed nonexchange transactions.

# Surgent Question: #302743

**FAR CPA Blueprint:** 4D9 - Budgetary Accounting and Encumbrances

**Question Statement:**

Which of the following is **not** required in the budgetary comparison schedule presented by a state or local government as part of required supplementary information?

A. The original budget
B. The final appropriated budget
>>C. Variances between the final budget and actual amounts
D. Actual inflows, outflows, and balances stated on a budgetary basis

**Surgent Question Explanation:**

The answer choice “variances between the final budget and actual amounts” is correct. GASB standards require, at a minimum, that the first three columns of the budgetary comparison schedule be presented: original budget, the final appropriated budget, and actual inflows, outflows, and balances stated on a budgetary basis. The variance column, traditionally reflected as the fourth column, is considered optional. While comparisons of actual amounts with the final budget help policymakers to determine the extent to which program managers exercised care and accountability over use of public resources, this calculation is ***not*** required to be included on the budgetary comparison schedule (despite most governments presenting it).

The answer choices “the original budget,” “the final appropriated budget,” and “actual inflows, outflows, and balances stated on a budgetary basis” are all *required* in the budgetary comparison schedule; therefore, they are incorrect answers. The original budget reflects the formal intention of the legislative body to dedicate resources to specific programs. An appropriation is an amount authorized by a legislative body to make expenditures and incur liabilities for a specific purpose. Budgetary basis of accounting reflects regulations governing budgeting arising from state or local laws or ordinances that may differ from GAAP.

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# Surgent Question: #102907

**REG CPA Blueprint:** 1A1 - Regulations Governing Practice Before the Internal Revenue Service

**Question Statement:**

A client claims to have driven 50,000 miles for business purposes during the preceding year and wishes to deduct all of the mileage. The CPA suspects that the client is overstating the amount of mileage actually driven for business purposes. According to Treasury Department Circular 230, the CPA should do which of the following?

A. Deduct only the amount of mileage for business purposes that the CPA believes is reasonable.
>>B. Make reasonable inquiries about the information supplied.
C. Prepare the tax return without asking any questions.
D. Put a note in the client's file indicating that the client made an oral declaration about mileage driven for business purposes.

**Surgent Question Explanation:**

Treasury Circular 230 states in Section 10.34(d) that the CPA must *make reasonable inquiries* for incorrect, inconsistent, or incomplete information. If the CPA feels the information is incorrect, they should perform due diligence to ascertain the correct information.

Questioning the taxpayer will satisfy the due diligence that is required per Treasury Circular 230; Section 10.22 requires the CPA to exercise due diligence in preparing, approving, and/or filing tax returns, documents, affidavits, etc. relating to IRS matters.

Further, the CPA cannot sign the return if they feel there is a willful attempt to understate the liability (overstating the mileage deduction). Treasury Circular 230, Section 10.34(a), notes the CPA may not sign a tax return, or advise a position on a tax return, willfully, recklessly, or through gross incompetence if it lacks reasonable basis, is an unreasonable position (IRC Section 6694(a)(2)), is a willful attempt to understate liability (IRC Section 6694(b)(2)(A)), or is a reckless, intentional disregard of rules and regulations (IRC Section 6694(b)(2)(B)).

Once the CPA makes reasonable inquiries about the mileage deduction to the taxpayer and is satisfied with the answer, the CPA may sign the return and will be compliant with Circular 230.

# Surgent Question: #102908

**REG CPA Blueprint:** 1A2 - Internal Revenue Code and Regulations Related to Tax Return Preparers

**Question Statement:**

Which of the following individuals is acting as a tax return preparer under IRS regulations?

>>A. A CPA who prepares a substantial portion of a claim for refund of tax for a client
B. A CPA who prepares a tax return for a taxpayer under the Volunteer Income Tax Assistance program
C. An employee of the tax department of a corporation who prepares a tax return on behalf of the corporation's wholly owned subsidiary
D. An employee of the tax department of a corporation who prepares a claim for refund on behalf of the corporation's parent company, which owns 100% of the corporation

**Surgent Question Explanation:**

IRS Regulation Section 301.7701-15 provides the definition of a "tax return preparer" and explicitly states which types of individuals are *not* tax return preparers. It specifically states that a tax return preparer "is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code."

The code section excludes preparers who participate in a Volunteer Income Tax Assistance (VITA) program and employees of an organization that prepare the organization's taxes. This would include employees of a subsidiary preparing taxes for the parent company.

# Surgent Question: #102909

**REG CPA Blueprint:** 1B - Licensing and Disciplinary Systems

**Question Statement:**

The only entity that can censure a CPA or revoke a license to practice as a CPA is:

A. the National Association of State Boards of Accountancy.
>>B. the state board of accountancy for the state in which the CPA practices.
C. the Securities and Exchange Commission.
D. the American Institute of Certified Public Accountants.

**Surgent Question Explanation:**

Only the state licensing board can revoke a member's license. The licensing authority and requirements for CPAs fall under the jurisdiction of the board of accountancy for the state, district, or country in which a CPA practices. State regulatory agencies (boards of accountancy) issue practice licenses to CPAs and only those agencies may act to affect those licenses. Those state regulatory agencies may take disciplinary action affecting practice licenses under statutes, regulations, and rulings of the state.

The other answer choices are incorrect:

- The National Association of State Boards of Accountancy (NASBA) is the national organization representing the state boards of accountancy.
- In adherence to the mission of the AICPA (American Institute of Certified Public Accountants), the AICPA seeks the highest possible level of uniform certification and licensing standards while promoting and protecting the CPA designation. The AICPA does not license CPAs and cannot revoke a member's license. However, according to section 700 of the AICPA Bylaws, the AICPA can terminate or suspend an individual's membership.
- The Securities and Exchange Commission (SEC) and other federal government agencies may, under federal law or regulation, discipline CPAs who practice before these agencies (that is, the CPAs will no longer have the ability to appear or practice in front of the agency). However, the SEC does not have the authority to revoke a CPA license.

# Surgent Question: #102910

**REG CPA Blueprint:** 1C1 - Audits, Appeals, and Judicial Process

**Question Statement:**

A taxpayer received a 90-day letter proposing a deficiency. The taxpayer challenged the proposed deficiency in the Small Cases Division of the U.S. Tax Court. If the taxpayer loses the case, then the decision is:

A. appealable to the regular division of the U.S. Tax Court.
B. appealable to the U.S. District Court if the deficiency is paid.
C. appealable to the U.S. Court of Federal Claims if the deficiency is paid.
>>D. **not** appealable.

**Surgent Question Explanation:**

A small tax case ("S case") tax dispute cannot exceed $50,000 for any one tax year. The taxpayer must request the S case specifically when filing in tax court.

There are several advantages in filing an S case:

- Taking the case to court without paying the questioned tax (as opposed to other courts that require payment first)
- Many locations throughout the country (Other tax courts have a minimal presence throughout the United States.)
- Less formal pretrial and trial procedures that allow the taxpayer to represent themselves, saving legal fees
- S case judges are more lenient in the acceptance of evidence provided by the taxpayer.

However, with the advantages, there is a potential disadvantage of *not being able to appeal* the decision once the case is decided. Neither the taxpayer nor the IRS may appeal.

# Surgent Question: #102911

**REG CPA Blueprint:** 1C2 - Substantiation and Disclosure of Tax Positions

**Question Statement:**

A reportable transaction is one with respect to which additional information is required to be included with a federal income tax return because the transaction is of a type, according to an IRS determination, that has:

A. a significant tax impact in the return year.
>>B. the potential for tax avoidance or evasion.
C. a potential impact on more than one taxpayer.
D. a significant tax impact on future years' returns.

**Surgent Question Explanation:**

Congress has enacted a series of income tax laws designed to halt the growth of *abusive tax avoidance transactions,* including the disclosure of reportable transactions. Each taxpayer that has participated in a reportable transaction and that is required to file a tax return must disclose information for each reportable transaction in which the taxpayer participates.

# Surgent Question: #102912

**REG CPA Blueprint:** 1D1 - Common Law Duties and Liabilities to Clients and Third Parties

**Question Statement:**

A CPA quickly prepares the financial statements for WSA Co. without noticing that an asset was inadvertently overstated on the balance sheet by 10%. An investor who had purchased stock in WSA based on the financial statements lost $10,000 as a result of the investment. The investor claims that WSA committed fraud. Which of the following is true concerning whether fraud was committed?

A. Fraud was committed because the balance sheet is misstated.
B. Fraud was **not** committed because the investor's damages are not material.
C. Fraud was committed because the reliance was placed on the statements by the investor.
>>D. Fraud was **not** committed because the misstatement was due to negligence.

**Surgent Question Explanation:**

The elements of fraud are:

- misrepresentation (false representation, concealment, or nondisclosure),
- knowledge of falsity (scienter),
- intent to defraud (i.e., to induce reliance),
- justifiable reliance, and
- resulting damage.

Although the elements of justifiable reliance and resulting damage are present, there was no *intent* by the auditors to defraud. The facts specifically show that the auditors "without noticing" and "inadvertently" overstated the balance of the assets by 10%. This is not fraud due to the lack of intent, but it may be considered negligence.

# Surgent Question: #102913

**REG CPA Blueprint:** 2A1 - Authority of Agents and Principals

**Question Statement:**

Under agency law, which of the following sets of categories refer to principals?

A. Formal, mutual, and informal
B. Actual, express, and implied
C. General, special, and gratuitous
>>D. Disclosed, partially disclosed, and undisclosed

**Surgent Question Explanation:**

This is a definitional type of question. Under agency law, principals are classified into three categories: disclosed principals, partially disclosed principals, and undisclosed principals.

**Helpful Hint:** Create an acronym for the categories such as DUPA. (The "A" is for agency so you know it relates to agency relationships.)

# Surgent Question: #102914

**REG CPA Blueprint:** 2A2 - Duties and Liabilities of Agents and Principals

**Question Statement:**

Brasher, who owns an office building, hires a real estate agent to find a buyer for the building. Shortly thereafter, Jaxson hires the same real estate agent to find an office building for purchase. If the agent sells Brasher's office building to Jaxson without disclosing the agency relationship with Brasher, the real estate agent has breached which of the following duties?

A. Duty to inform
B. Duty of due diligence
C. Duty of obedience
>>D. Duty of loyalty

**Surgent Question Explanation:**

Duty of loyalty requires the agent to burnish undivided loyalty to the principal with no conflicts of interest. Clearly, acting on behalf of the seller ***and*** buyer simultaneously reflects a conflict of interest as the real estate agent is working both sides of the transaction.

Duty of obedience relates to the real estate agent following instructions and does not relate to the agent's conflicts of interests or primary responsibilities. Duty to inform and duty of due diligence are not legal duties and obligations in an agent-principal relationship.

# Surgent Question: #102915

**REG CPA Blueprint:** 2B2 - Performance

**Question Statement:**

Excusing performance of a contract due to very large unforeseen expenses **not** contemplated by the parties to the contract at the time of the formation of the contract is the definition of which of the following?

A. Tender of performance
B. Anticipatory repudiation
>>C. Commercial impracticality
D. Impossibility of performance

**Surgent Question Explanation:**

Under the Uniform Commercial Code (UCC), excuses for nonperformance include performance conditions that have been made impractical due to conditions or occurrences that underly the contract’s basic assumptions and which the parties attempted in good faith. This is called commercial impracticality.

Large expenses make the contract impractical, not impossible. Anticipatory repudiation indicates an expectation of nonperformance before this threshold, and tender of performance is incorrect because it merely indicates one party will perform their duties.

# Surgent Question: #102916

**REG CPA Blueprint:** 2B3 - Discharge, Breach, and Remedies

**Question Statement:**

CJN Corp. contracts with James, Inc. to sell James's 130 acres of oceanfront property and requires James to submit the entire balance upon closing. CJN refuses to close the sale. James has which of the following remedies available to it?

>>A. Compensatory damages or specific performance
B. Specific performance and compensatory damages
C. Consequential damages or punitive damages
D. Punitive damages and compensatory damages

**Surgent Question Explanation:**

The sale of oceanfront property by CJN represents a sale of goods. Failure to close when the contract terms are met represents a breach of contract on behalf of CJN. James may seek compensatory damages for the difference between the contract price upon closing and the fair market value of another suitable property. However, because the property is specific in nature (no two properties are identical), James may also seek specific performance that requires CJN to deliver the exact property to James. James can elect either remedy but ***not both.***

Punitive damages are not able to be sought for land disputes without injury.

# Surgent Question: #102917

**REG CPA Blueprint:** 2D - Federal Laws and Regulations (e.g., Employment Tax, Qualified Health Plans & Worker Classification)

**Question Statement:**

Funding from FICA contributions is provided to assist qualifying individuals in each of the following groups, **except:**

A. retirees.
>>B. unemployed workers.
C. survivors of deceased workers.
D. elderly individuals requiring medical services or hospitalization.

**Surgent Question Explanation:**

FICA (commonly referred to as Social Security) contributions are predominately used to help support retired workers, survivors of deceased workers, disabled workers, and individuals on Medicare. It is *separate* from unemployment insurance that benefits unemployed workers.

# Surgent Question: #102918

**REG CPA Blueprint:** 2E1 - Selection and Formation of Business Entity and Related Operation and Termination

**Question Statement:**

A U.S. citizen and an individual who is a resident and citizen of Australia want to form a business association to sell farm equipment in the United States. They want limited liability to the extent of their investments, to be taxed as a flow-through, and to both actively participate in management. Which of the following types of business organizations best fits their needs?

A. S corporation
B. C corporation
C. Limited partnership (LP)
>>D. Limited liability company (LLC)

**Surgent Question Explanation:**

This question is best assessed through process of elimination:

- The owners want to be taxed as a flow-through, so C corporation election is not possible.
- They both want to actively participate, so limited partnerships are not an option as they require at least one general and at least one limited partner.
- Because one of the two owners is a nonresident alien, the two cannot elect S corporation status.

The only remaining option that matches all their wants is a limited liability company, or LLC.

# Surgent Question: #102919

**REG CPA Blueprint:** 3A1 - Basis and Holding Period of Assets

**Question Statement:**

Smith owns vacant lot A, with a basis of $10,000 and a fair market value of $25,000. Jones owns lot B, with a basis of $11,000 and a fair market value of $22,000. Smith and Jones agree to trade lots, with Jones paying Smith $3,000. After the exchange, what amount is Smith's basis in lot B?

A. $7,000
>>B. $10,000
C. $11,000
D. $22,000

**Surgent Question Explanation:**

A partially nontaxable exchange is an exchange in which the taxpayer receives unlike property or money in addition to like property. The basis of the property the taxpayer receives is the same as the basis of the property the taxpayer gave up, with the following adjustments:

1. Decrease the basis by the following amounts:
    a. Any money the taxpayer receives
    b. Any loss the taxpayer recognizes on the exchange
2. Increase the basis by the following amounts:
    a. Any additional costs the taxpayer incurs
    b. Any gain the taxpayer recognizes on the exchange
        - The recognized gain is the lesser of the cash (boot) received or gain realized on the exchange.
        - Gain on exchange = Fair market value (FMV) received (Asset + Cash) - (Basis of the asset given up)

First, calculate the gain on the exchange, which is equal to the FMV of the assets received minus the basis given up.

- Jones gives land of $22,000 and cash of $3,000 = $25,000 provided
- Smith trades land with a basis of $11,000.
- Smith's gain on the exchange = $25,000 received ($22,000 from Jones's FMV land + $3,000 Cash) − $10,000 given up (Basis of Smith's land) = $15,000
- Since cash received was $3,000, it is the lesser of the $15,000 gain on exchange.
- The $3,000 is the gain recognized that will be used to calculate Smith's new basis.

**Basis calculation:**

| | | |
|---|---|---|
| Asset given | $10,000 | |
| − Cash received | 3,000 | |
| | $ 7,000 | |
| + Gain recognized | 3,000 | (lesser of cash or gain on exchange) |
| New Basis | $10,000 | |

# Surgent Question: #102920

**REG CPA Blueprint:** 3A3 - Amount and Character of Gains and Losses, and Netting Process (Including Installment Sales)

**Question Statement:**

An accrual-basis taxpayer sold land for $100,000 on July 1, year 1, and received $20,000 cash and a note for $80,000. The taxpayer's basis in the asset is $60,000. What amount of gain, if any, should the taxpayer report for year 1, if the transaction qualified under the installment sale method?

A. 0
>>B. $8,000
C. $20,000
D. $40,000

**Surgent Question Explanation:**

The assumption made in this question is that the note will begin to be paid after year 1 and the cash is paid immediately.

An installment sale is a sale of property where the taxpayer receives at least one payment after the tax year in which the sale occurs. The taxpayer is required to report gain on an installment sale under the installment method per the gross profit percentage.

First, calculate the gross profit:

- The gross profit is the selling price minus the basis.
- $100,000 (Selling price) − $60,000 (Basis) = $40,000 (Gross profit)

Second, calculate the gross profit percentage:

- The gross profit percentage is the gross profit from the sale divided by the contract price.
- $40,000 (Gross profit) ÷ $100,000 (Contract price) = 40%

Third, calculate the amount recognized in year 1 taxes:

- $20,000 cash received in year 1 multiplied by the gross profit percentage of 40%
- $20,000 × 40% = $8,000

# Surgent Question: #102921

**REG CPA Blueprint:** 3A3 - Amount and Character of Gains and Losses, and Netting Process (Including Installment Sales)

**Question Statement:**

A taxpayer received an investment property from a former spouse as a result of a divorce. The former spouse had purchased the property for $100,000 several years before they got married, and the fair market value of the property was $175,000 at the time of the divorce. One year after receiving the property, the taxpayer obtained a loan secured by the property in the amount of $50,000. One year after obtaining the loan, the taxpayer sold the property for $190,000 and used the proceeds to repay the loan. What amount is the taxpayer's recognized tax gain from the sale of the property?

A. $15,000
B. $40,000
>>C. $90,000
D. $140,000

**Surgent Question Explanation:**

First, the basis needs to be determined and will use either the original value (spouse's basis) of $100,000 or the current fair market value of $175,000.

IRS Publication 504 states that the original (spouse's) basis should be used when property is transferred in a case of a divorce. The amount of the property at the time of divorce was $100,000, the original basis that reflects the spouse's purchase price.

Since the mortgage was not assumed (taken over) by the buyer, it is not used in the calculation.

IRS Publication 527 states, "To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get your gain or loss."

| | |
|---|---|
| Selling price | $190,000 |
| - Adjusted basis | ($100,000) |
| Gain or loss | $ 90,000 |

 

# Surgent Question: #102922

**REG CPA Blueprint:** 3A4 - Related Party Transactions (Including Imputed Interest)

**Question Statement:**

Lamb purchased real property for $20,000 and sold it the next year to Gray, Lamb's child, for the fair market value of $12,000. Later, Gray sold the property to Hogan, who is not related to Gray or Lamb, for $15,000. What amount, if any, should be recognized by Gray?

A. $5,000 loss
B. $3,000 loss
>>C. $0
D. $3,000 gain

**Surgent Question Explanation:**

Special rules apply to like-kind exchanges between related persons. These rules affect both direct and indirect exchanges. A loss on the sale or exchange of property between related persons is not deductible. The gain or loss on the original exchange must be recognized as of the date of the later disposition. Related persons include, for example, the taxpayer and a member of the taxpayer's family (spouse, brother, sister, parent, child, etc.). (IRS Publication 544)

| | |
|---|---|
| Land sold to Gray, Lamb's child | $12,000 |
| Lamb basis | (20,000) |
| Deferred loss due to relative | $(8,000) |
| | |
| Sale to Hogan | $15,000 |
| Gray's basis | (12,000) |
| Gain | $ 3,000 |

The son, Gray, will not recognize the $3,000 sale to Hogan because the deferred loss of $8,000, from the transaction with his father, will offset that amount. Gray needed to wait until he sold the property to a non-relative in order to recognize his initial loss.

# Surgent Question: #102923

**REG CPA Blueprint:** 3B - Cost Recovery (Depreciation, Depletion, and Amortization)

**Question Statement:**

ABC Industries, a C corporation, was incorporated on March 1, year 2, and elected a calendar year-end. On April 15, year 2, prior to commencing business operations, ABC purchased the assets of DEF Corp. for $350,000. Of this amount, $90,000 was allocated to goodwill. On May 1, year 2, ABC commenced business operations. What amount of goodwill amortization can ABC claim on its year 2 corporate tax return?

>>A. $4,000
B. $4,250
C. $5,000
D. $6,000

**Surgent Question Explanation:**

There are two issues in the depreciation of the goodwill of a Section 197 asset:

1. When it was put into service
2. How many years are used to depreciate the asset

A Section 197 asset is depreciated over a 15-year time period as soon as it is put into service. For this problem, the asset was put into service on May 1 and should be depreciated from May until December, or 8 months/12 months.

The calculation is as follows:

- $90,000 of goodwill ÷ 15 years= $6,000 per year
- $6,000 per year × (8/12) of the year put into service = $4,000

# Surgent Question: #102924

**REG CPA Blueprint:** 3C - Gift Taxation

**Question Statement:**

Baker made the following gifts: a $100,000 house to Baker's child, a $50,000 automobile to a friend, $40,000 cash to Baker's spouse, and $60,000 capital stock to a qualified charity. Baker and Baker's spouse do **not** elect gift splitting. What is the total taxable gift before considering the gift tax annual exclusion?

A. $50,000
>>B. $150,000
C. $190,000
D. $210,000

**Surgent Question Explanation:**

The total taxable gift is calculated as follows:

| | |
|---|---|
| House to Baker's child | $100,000 |
| Automobile to a friend | 50,000 |
| Total taxable gift | $150,000 |

Per the instructions for IRS Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* gifts to a spouse do not count as gifts. However, gifts to children are included in taxable gifts. The automobile is also included as a gift. The charitable contribution would be used as an itemized deduction if the standard deduction is not used, but it is not considered a gift.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- Gifts, excluding gifts of future interests, that are not more than the annual exclusion for the calendar year
- Tuition or medical expenses paid directly to an educational or medical institution for someone else
- Gifts to the taxpayer's spouse if the spouse is a U.S. citizen
- Gifts to a political organization for its use
- Gifts to certain exempt organizations described in IRC 501(c)(4), 501(c)(5), and 501(c)(6)
- Gifts to charities

**IRS Publication 559**

# Surgent Question: #102925

**REG CPA Blueprint:** 4A - Gross Income (Inclusions and Exclusions)

**Question Statement:**

An individual taxpayer had the following transactions during the current year:

| | |
|---|---|
| Workers' compensation payments | $30,000 |
| Damages received for slander | 40,000 |
| Loss on the sale of a personal residence | 75,000 |
| W-2 wages | 80,000 |

What is the taxpayer's adjusted gross income?

A. $107,000
B. $110,000
>>C. $120,000
D. $147,000

**Surgent Question Explanation:**

The adjusted gross income is $120,000:

**Taxable:**

| | |
|---|---|
| W-2 wages | $ 80,000 |
| Damages received for slander | 40,000 |
| Adjusted gross income: | $120,000 |

**Nontaxable:**

| | |
|---|---|
| Loss on the sale of a personal residence | $75,000 |
| Workers' compensation payments | 30,000 |

**Nontaxable income:**

1. Amounts the taxpayer receives as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act.
2. Losses from the sale of personal-use property, such as a home or car, are not tax deductible.

**Taxable income:**

1. In most cases, the taxpayer must include in gross income everything they receive in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options.
2. Court awards and damages: To determine if settlement amounts received by compromise or judgment must be included in income, the taxpayer must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income:
   - Interest on any award
   - Compensation for lost wages or lost profits in most cases
   - Punitive damages in most cases (It does not matter if they relate to a physical injury or physical sickness.)

**IRS Publication 525**

# Surgent Question: #102926

**REG CPA Blueprint:** 4A - Gross Income (Inclusions and Exclusions)

**Question Statement:**

Emmett loaned Baker $10,000. Baker filed for bankruptcy last year, and Emmett was notified that Emmett would receive $0.20 on the dollar. In the current year, Emmett received $1,500 as the final settlement. The loan is nonbusiness. How should Emmett report the loss?

A. $8,000 short-term capital loss last year and $500 ordinary loss in the current year
B. $8,000 short-term capital loss last year and $500 capital loss in the current year
C. $8,500 ordinary loss in the current year
>>D. $8,500 short-term capital loss in the current year

**Surgent Question Explanation:**

Nonbusiness bad debts give rise to short-term capital losses and business bad debts give rise to ordinary losses. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. (IRC Section 166)

Since this is a nonbusiness bad debt, the loss will be considered a short-term capital loss. Baker filed for bankruptcy, which indicates that the debt is worthless. Baker received $1,500 during the bankruptcy proceedings, leaving $8,500 as a loss ($10,000 − $1,500). This amount will be the short-term capital loss for the year.

# Surgent Question: #102927

**REG CPA Blueprint:** 4B - Reporting of Items from Pass-Through Entities

**Question Statement:**

An S corporation pays one of its individual shareholders for services rendered to the S corporation, and a general partnership pays one of its partners for services rendered to the partnership. Which of the following statements is accurate regarding these payments?

>>A. The S corporation should classify the payments as deductible wages reportable on Form W-2.

B. The partnership should classify the payments as deductible wages reportable on Form W-2.

C. The S corporation should classify the payments as nondeductible dividends reportable on Form 1099-DIV.

D. The partnership should classify the payments as nondeductible partnership distributions reportable on Form K-1.

**Surgent Question Explanation:**

Courts have consistently held that S corporation officers and shareholders who provide more than minor services to their corporation and receive, or are entitled to receive, compensation are subject to federal employment taxes. These payments to the corporate officer are treated as wages, and the fact that an officer is also a shareholder does not change this requirement.

Partners are not employees and *should not* be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (IRS Form 1065) to the partner. These payments are considered deductible distributions to the corporation.

# Surgent Question: #102928

**REG CPA Blueprint:** 4C - Adjustments and Deductions to Arrive at Adjusted Gross Income and Taxable Income

**Question Statement:**

An individual taxpayer received a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, from a small partnership in which the taxpayer owns a 50% interest. The qualified business income amount attributable to the taxpayer is $70,000. That is the taxpayer's only qualified business income, and the taxpayer has no capital gains or other investments. Ignoring the W-2 limitation, what is the net amount of increase to taxable income from the partnership income?

A. $0
B. $14,000
>>C. $56,000
D. $70,000

**Surgent Question Explanation:**

Many individuals, including owners of businesses operated through sole proprietorships, partnerships, S corporations, trusts, and estates, may be eligible for a qualified business income deduction, also called the Section 199A deduction. Some trusts and estates may also claim the deduction directly.

The deduction allows them to deduct up to 20% of their qualified business income (QBI). Income earned by a C corporation or by providing services as an employee is not eligible for the deduction.

**Qualified business income (QBI) calculation:**

| | |
|---|---|
| Taxpayer's qualified business income: | $70,000 |
| Deduction amount ($70,000 × 0.20) | 14,000 |
| Net amount of increase to taxable income | $56,000 |

# Surgent Question: #102929

**REG CPA Blueprint:** 4D - Passive Activity Losses (Excluding Foreign Tax Credit Implications)

**Question Statement:**

Which of the following would be treated as passive activity income under the passive activity loss rules?

A. Dividend income from a taxpayer's investment portfolio
>>B. Income from a taxpayer's limited partnership interest
C. Commission received from selling vacation property
D. Rental income from real estate in which the taxpayer materially participated as a real estate professional

**Question Explanation:**

Income from a taxpayer's limited partnership interest is specifically excluded from being material participation and is therefore a passive activity. IRC Section 469(h)(2) states, "No interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates."

According to IRS Publication 925 (*Passive Activity and At-Risk Rules*), passive activity income includes all income from passive activities and generally includes gain from disposition of an interest in a passive activity or property used in a passive activity.

Passive activity income does *not* include the following items:

- Portfolio income: This includes interest, *dividends,* annuities, and royalties not derived in the ordinary course of a trade or business. It includes gain or loss from the disposition of property that produces these types of income or that is held for investment. The exclusion does not apply to self-charged interest treated as passive activity income.
- Personal service income: This includes salaries, wages, *commissions,* self-employment income from trade or business activities in which the taxpayer materially participated, deferred compensation, taxable Social Security and other retirement benefits, and payments from partnerships to partners for personal services.
- A rental activity is a passive activity even if the taxpayer materially participated in that activity, unless they materially participated as a *real estate professional* (as in this question).

# Surgent Question: #102930

**REG CPA Blueprint:** 4E - Loss Limitations

**Question Statement:**

A taxpayer plans to sell the following assets:

- A home rented during the entire year by the taxpayer's tenant at a market rental rate
- An automobile used by the taxpayer solely for recreational purposes
- A show dog held by the taxpayer for hobby purposes
- Common stock held by the taxpayer for investment purposes

If the taxpayer projects a $10,000 loss on each asset sale, then the losses will reduce adjusted gross income by what amount?

A. $30,000
B. $23,000
C. $20,000
>>D. $13,000

**Surgent Question Explanation:**

Losses from the sale of personal-use property, such as a taxpayer's home or car, are not tax deductible. However, property used in a business for a year is subject to the Section 1231 rules, which allow losses against ordinary income.

Hobby losses are not deductible. The loss of common stock is a capital loss subject to the $3,000 limitation (for married filing jointly).

The recognized loss includes the following:

```
$10,000 Loss on rental home
  3,000 Loss on stock (subject to capital loss limits)
$13,000 Total loss for the year
```

# Surgent Question: #102931

**REG CPA Blueprint:** 4F - Filing Status

**Question Statement:**

The spouse of a married taxpayer died on January 15, year 1. The taxpayer's qualifying child moved to live with grandparents in their home on August 30, year 2. If the taxpayer did **not** remarry before the end of year 2, then which filing status should the taxpayer choose for year 2?

A. Surviving spouse
>>B. Head of household
C. Married filing jointly
D. Married filing separately

**Question Explanation:**

The more beneficial filing status for the spouse to use is "surviving spouse," which can be used for two tax years after one of the spouses passes away. However, the qualifying child moved to live with the grandparents, which precluded the taxpayer from using the surviving spouse status. The qualifying child would need to live with the taxpayer the entire year to use the filing status.

*Head of household* can be used if the qualifying child lived with the taxpayer for at least half the year, which is the case in this scenario.

# Surgent Question: #102932

**REG CPA Blueprint:** 4G - Computation of Tax and Credits

**Question Statement:**

Interest on a tax deficiency begins to accrue on the date on which:

>>A. the tax was due, without regard to extension of time to file.
B. the tax was redetermined by the IRS upon audit.
C. a court decision was entered in favor of the IRS.
D. a notice of levy was mailed to the taxpayer.

**Surgent Question Explanation:**

IRC Section 6601 (*Interest on Underpayment, Nonpayment, or Extensions of Time for Payment, of Tax*) states the following:

"If any amount of tax imposed by this title (whether required to be shown on a return, or to be paid by stamp or by some other method) is not paid on or before the *last date prescribed for payment,* interest on such amount at the underpayment rate established under [IRC] section 6621 shall be paid for the period *from such last date* to the date paid.… The last date prescribed for payment shall be determined w*ithout regard to any extension* of time for payment or any installment agreement entered into under [IRC] section 6159." *(Emphasis added)*

# Surgent Question: #102933

**REG CPA Blueprint:** 5A - Tax Treatment of Formation and Liquidation of Business Entities

**Question Statement:**

As part of a liquidating distribution, a partner receives $8,000 cash and land with a fair market value of $12,000 and a basis of $7,000. The partner's basis in the partnership prior to the distribution was $10,000. What is the partner's basis in the land immediately after the distribution?

>>A. $2,000
B. $7,000
C. $8,000
D. $12,000

**Surgent Question Explanation:**

The basis in the land immediately after the distribution is $2,000, calculated as follows:

| | |
|---|---|
| Partner's basis | $10,000 |
| Less: Cash received | 8,000 |
| Remaining basis | $ 2,000 |

Since this is a liquidating distribution, the basis of the property is equal to the adjusted basis of the interest in the partnership reduced by the amount of any money distributed to the partner in the same transaction.

# Surgent Question: #102934

**REG CPA Blueprint:** 5B - Differences Between Book and Tax Income (Loss)

**Question Statement:**

A company reported net income of $400,000 on its year 2 audited financial statements. The company reported $240,000 in tax expenses to arrive at its net income for financial statement purposes in year 2, as detailed below:

| | |
|---|---|
| Federal income tax paid to the IRS | $150,000 |
| State income tax paid to state Q | 50,000 |
| Foreign income tax paid to country M | 20,000 |
| Property tax paid to state Q | 15,000 |
| Sales tax paid to state Q | 5,000 |

The company will not take the foreign tax credit. What is the company's deduction for taxes paid on its year 2 federal income tax return?

A. $70,000
>>B. $90,000
C. $170,000
D. $240,000

**Surgent Question Explanation:**

According to IRS Publication 535 (*Business Expenses*), many taxes are deductible as a cost of doing business. This includes state income tax, foreign income tax, property tax, and sales tax. Federal income taxes *cannot* be deducted.

The total deduction in this question is $90,000:

| | |
|---|---|
| State income tax paid to state Q | $50,000 |
| Foreign income tax paid to country M | 20,000 |
| Property tax paid to state Q | 15,000 |
| Sales tax paid to state Q | 5,000 |
| Total deduction | $90,000 |

# Surgent Question: #102935

**REG CPA Blueprint:** 5C1 - Computations of Taxable Income, Tax Liability, and Allowable Credits

**Question Statement:**

A C corporation has a net loss from operations of $500,000, a long-term capital gain of $20,000, and a short-term capital loss of $50,000 for the current year. What is the corporation's loss for the year?

A. $(530,000)
>>B. $(500,000)
C. $(497,000)
D. $(483,000)

**Surgent Question Explanation:**

The long-term capital gain ($20,000) nets with the short-term capital loss ($50,000) to have a net capital loss of $30,000. This $30,000 loss is carried to other tax years and is deducted from any net capital gains that occur in those years. The $500,000 loss is the only amount recognized for this year. The capital losses can only be used to offset capital gains in carryover years.

# Surgent Question: #102936

**REG CPA Blueprint:** 5C3 - Entity/Owner Transactions, Including Contributions, Loans, and Distributions

**Question Statement:**

In the current year, Anderson, Branch, and Campbell formed Orange Corp. Anderson transferred to the corporation land with an adjusted basis of $90,000 and a fair market value of $100,000; Branch transferred to the corporation equipment with an adjusted basis of $50,000 and a fair market value of $100,000; and Campbell will render services to the corporation. Each shareholder received 5,000 shares of Orange Corp. stock, worth a total of $100,000. What amount of income must Campbell report as a result of this transfer?

A. $0
B. $10,000
C. $50,000
>>D. $100,000

**Surgent Question Explanation:**

The $100,000 worth of stock was provided for the services that Campbell performed for the business. This is an economic benefit received and must be recognized as gross income. Since Campbell does not have control over the corporation, Campbell must recognize the equivalent cash value of stock provided as income.

# Surgent Question: #102937

**REG CPA Blueprint:** 5C4 - Consolidated Tax Returns

**Question Statement:**

Peach, Inc. files a consolidated federal income tax return with its 100%-owned domestic subsidiaries. In year 2, members of the consolidated group reported net book income (loss) as follows:

| | |
|---|---|
| Peach, Inc. | $ 125,000 |
| Apple, Inc. | 45,000 |
| Blueberry, Inc. | (100,000) |

Apple paid $50,000 in dividends to Peach in year 2. The dividends are included in Peach's net income reported above. Based on the information provided, what is the group's consolidated taxable income for year 2?

>>A. $20,000
B. $30,000
C. $35,000
D. $70,000

**Surgent Question Explanation:**

Small business investment companies can deduct 100% of the dividends received from taxable domestic corporations. Peach will receive 100% of the dividends-received deduction (DRD) because it owns Peach, which is a taxable domestic corporation.

| | |
|---|---|
| Peach, Inc. | $125,000 |
| Apple, Inc. | 45,000 |
| Blueberry, Inc. | (100,000) |
| Total income | $ 70,000 |
| Dividends-received deduction (100%) | (50,000) |
| Income after DRD | $ 20,000 |

# Surgent Question: #102938

**REG CPA Blueprint:** 5D1 - Eligibility and Election

**Question Statement:**

Which of the following shareholders is **ineligible** to own the stock of an S corporation?

>>A. Domestic C corporation
B. Resident alien individual
C. Estate of a deceased U.S. citizen
D. Grantor trust created by a U.S. citizen

**Surgent Question Explanation:**

To qualify for S corporation status, a corporation must meet the following requirements:

- Be a domestic corporation
- Have only allowable shareholders:
  - May be individuals, certain trusts, and estates and
  - *May not be corporations,* partnerships, or nonresident alien shareholders
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations).

A domestic C corporation is *not* an allowable shareholder for an S corporation.

# Surgent Question: #102939

**REG CPA Blueprint:** 5D2 - Determination of Ordinary Business Income (Loss) and Separately Stated Items

**Question Statement:**

Chris owns 25%, Tracy owns 35%, and Sam owns 40% of a business that has always been treated as an S corporation for federal income tax purposes. During the current year, $500,000 of taxable income is generated. Who is responsible for claiming the taxable income?

A. The corporation
B. Chris, Tracy, and Sam, according to their profit distribution agreement
>>C. Chris, Tracy, and Sam, according to their percentage of ownership
D. Chris, Tracy, and Sam equally

**Surgent Question Explanation:**

Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income.

Each shareholder's pro rata share items are figured separately for each period on a daily basis, based on the percentage of stock (ownership) held by the shareholder on each day.

# Surgent Question: #102940

**REG CPA Blueprint:** 5D5 - Built-In Gains Tax

**Question Statement:**

A C corporation made a proper S election and will be treated as an S corporation as of the first day of year 2. In this case, the corporation is:

A. subject to built-in gains tax for the 10-year period beginning with the first day of year 2.
B. subject to built-in gains tax for the 7-year period beginning with the first day of year 2.
C. **not** subject to built-in gains tax if year 4 is the first year it sells assets that it held as a C corporation.
>>D. **not** subject to built-in gains tax if year 7 is the first year it sells assets that it held as a C corporation.

**Surgent Question Explanation:**

After 5 years as an S corporation, the corporation is not required to recognize gains as the previous C corporation because the recognition period has expired. Since 7 years have transpired, all gains made when selling its assets will be treated as being sold under S corporation rules.

The term "recognition period" means the 5-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. (IRC Section 1374(d))

# Surgent Question: #102941

**REG CPA Blueprint:** 5E3 - Partnership and Partner Elections

**Question Statement:**

Which of the following conditions is sufficient for a partnership to change its otherwise required taxable year?

A. The partners unanimously agree to a deferral of exactly six months.
B. By majority vote, the partners agree to a deferral of exactly six months.
C. The partnership prefers to use a calendar year in order to substantially defer the partners' tax liability.
>>D. The partnership makes an election for a different taxable year, which has a deferral of exactly three months.

**Surgent Question Explanation:**

A deferral period of three months or less is required before an election of a different taxable year can be made. In this question, the partnership has a deferral period of "exactly three months," which is within the time frame allowed by IRS regulations.

IRS Regulation Section 1.444-1T states, "In the case of a partnership, S corporation, or personal service corporation changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of (A) three months, or (B) the deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section."

# Surgent Question: #102942

**REG CPA Blueprint:** 5E4 - Transactions Between a Partner and the Partnership (Including Services Performed by a Partner and Loans)

**Question Statement:**

Lundy, an individual, controls 55% capital interest in a partnership and contributed six acres of land to the partnership. The property had a fair market value of $41,000. Lundy's basis in the property was $35,000. Two years later, the partnership sold the land to an unrelated party for $44,000. What amount of gain on the sale should be allocated to Lundy?

A. $1,650
B. $2,700
C. $4,950
>>D. $7,650

**Surgent Question Explanation:**

The initial gain of transferring the property is deferred due to Lundy obtaining stock and control of the corporation. Once the asset is sold, Lundy's initial gain is recognized as well as the percentage ownership gain in the asset.

**Lundy's gain:**

| | |
|---|---|
| Fair market value (FMV) when transferred to the corporation | $41,000 |
| Basis before transfer | 35,000 |
| Deferred gain | $ 6,000 |
| | |
| Sale price outside of the company | $44,000 |
| Basis to the company | 41,000 |
| Gain to the company | $ 3,000 |

- Amount of Lundy's gain on company sale: $3,000 × 0.55 = $1,650
- Total of Lundy's gain: $6,000 + $1,650 = $7,650

# Surgent Question: #102943

**REG CPA Blueprint:** 5E6 - Distribution of Partnership Assets

**Question Statement:**

Schmitt received $10,000 cash and an automobile with an adjusted basis of $15,000 and a fair market value of $5,000 from a partnership. Schmitt's basis in the partnership before the distribution was $5,000. What amount, if any, was Schmitt's recognized gain?

A. 0
>>B. $5,000
C. $10,000
D. $20,000

**Surgent Question Explanation:**

Schmitt's basis in the partnership of $5,000 is reduced by the cash of $10,000. Since the money he received is greater than his basis by $5,000, he recognizes this amount as a gain.

A current distribution reduces a partner's capital accounts and basis in their interest in the partnership ("outside basis") but does not terminate the interest. For current distributions, a partner recognizes gain to the extent the money they receive is greater than their outside basis immediately before the distribution (IRC Section 731(a)(1)).

# Surgent Question: #102944

**REG CPA Blueprint:** 5H2 - Unrelated Business Income

**Question Statement:**

For a not-for-profit organization with unrelated business income, the calculation of the unrelated business income tax is made upon:

A. all income from the organization.
>>B. the gross receipts from the unrelated business, less related deductions.
C. the gross receipts from the unrelated business, less related deductions, plus interest and dividends.
D. the gross receipts from the unrelated business, less related deductions and donations of the organization, less program expenses.

**Surgent Question Explanation:**

According to IRC Section 512(a), the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the deductions allowed which are directly connected with the carrying on of such trade or business.

 